SAFE HARBOR LEASING

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

DECEMBER 10, 1981

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CONTENTS

ADMINISTRATION WITNESS

	Page
The Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy	31

ADDITIONAL INFORMATION

Committee press release	2
Description of safe harbor leasing provisions under the accelerated cost recovery system	3
Prepared statement of:	
Hon. John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy	18
Charts:	
I. Investment credit and ACRS deductions	26
II. Lessee (new co.)	27
III. Lessor (taxable corp.)	28
Tables:	
1. Estimates of safe harbor leasing	29
2. Corporate income tax receipts	30
Senator Steven D. Symms, Idaho	47
Documents submitted by Senator Symms	48

COMMUNICATIONS

New York State Department of Transportation, letter and attachment	86

SAFE HARBOR LEASING

THURSDAY, DECEMBER 10, 1981

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to call, at 10:10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert J. Dole (chairman) presiding.

Present: Senators Dole, Symms, Grassley, Long, Byrd, Baucus, Moynihan, Boren, and Bradley.

[The committee press release announcing this hearing and the description by the Joint Committee on Taxation follow:]

Press Release No. 81-187

PRESS RELEASE

FOR IMMEDIATE RELEASE
December 4, 1931

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 Dirksen Senate Office Bldg.

SENATE FINANCE COMMITTEE TO REVIEW
SAFEHARBOR LEASING PROVISIONS

The Honorable Robert J. Dole (R., Kansas), Chairman of the Committee on Finance, announced today that the Committee will hold a session on Thursday, December 10, 1981, to review the safeharbor leasing provisions that were enacted as part of the Economic Recovery Tax Act of 1981.

The session will begin at 10:00 a.m. in Room 2221 of the Dirksen Senate Office Building.

The only witnesses to be heard will be representatives of the Treasury Department.

The purpose of the session is to gather information on the functioning of the leasing provisions since the tax bill was passed. The Committee will explore what kinds of corporations have engaged in leasing transactions, the volume of these transactions, and whether there is any need for additional corrective legislation.

Hearings to receive testimony from public witnesses may be scheduled at a later date.

P.R. # 81-187

DESCRIPTION OF
SAFE HARBOR LEASING PROVISONS
UNDER THE ACCELERATED COST RECOVERY SYSTEM

Scheduled for a Hearing

by the

Senate Committee on Finance

on

December 10, 1981

Prepared by the Staff

of the

Joint Committee on Taxation

December 9, 1981

JCX-37-81

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on December 10, 1981, on the subject of the safe harbor leasing provisions that were enacted as part of the Economic Recovery Tax Act of 1981.

The purpose of the hearing is to gather information on the functioning of the leasing provisions since the tax bill was enacted. (See Finance Committee press release no. 81-187, dated December 4, 1981.) The only witnesses scheduled to be heard at the December 10 hearing are representatives of the Treasury Department.

This document, prepared in connection with the hearing, provides an overall description of the safe harbor leasing provisions under the 1981 Act. The first part is a discussion of background (prior law and general reasons for the change). This is followed by an explanation of the provisions, including examples of how the provisions work in certain instances. The third part discusses pros and cons relating to the safe harbor leasing provisions. Finally, Appendix 1 presents an example of a sale-leaseback under present law; and Appendix 2 is a brief description of investment tax credit "strips."

Joint Committee on Taxation
December 9, 1981
JCX-37-81

SAFE HARBOR LEASING DESCRIPTION OF PROVISIONS UNDER THE ACCELERATED COST RECOVERY SYSTEM

I. Background

Prior law

The benefits of depreciation deductions and investment credits attributable to property generally are available only to the owner of the property. In many cases, companies in a tax loss position and thus unable to use currently the tax benefits of owning equipment have been able to obtain a portion of those benefits indirectly by leasing the equipment from companies having sufficient taxable income to use the tax benefits. The use of the tax benefits by the leasing company would be reflected in reduced rental payments charged to the loss company. The determination of whether these "lease financing" transactions should be treated for tax purposes in accordance with their form as leases or whether they should be recharacterized as in substance conditional sales or financing arrangements required a case-by-case analysis.

If a transfer of property were treated as a lease, reasonable rental payments by the lessee would be deductible by a lessee using the property in a trade or business. Also, since ownership under a lease remains with the lessor, the lessor would be entitled to recover its costs through depreciation and investment tax credits. The rental payments received by the lessor would be taxable at ordinary income rates.

On the other hand, if the transfer were a financing arrangement or conditional sale by the nominal lessor rather than a lease, the transferee of the property would not be able to deduct its payments as rent. The lessee could claim depreciation and investment tax credits since it would be treated as the owner of the property by virtue of the sale. For a lessee that is unable to utilize the tax benefits, the cost of acquiring the equipment would be higher than if the lessor took the benefits and passed them through to the lessee in the form of lower rents. For the lessor, no depreciation or investment credit would be allowed. Any difference between the lessor's basis in the property and the amount received from the lessee would be treated as gain from the sale of the property. Assuming the asset is a capital asset and has been held for more than 1 year, the gain would generally be capital gain (except for the portion treated as imputed interest under section 483, which is taxable at ordinary income rates). Installment reporting of the gain may be available to the seller.

For purposes of obtaining an advance letter ruling, the Internal Revenue Service in a series of Revenue Procedures (Rev. Procs. 75-21, 75-28, and 76-30) has established guidelines for determining whether a transaction is a lease or merely a financing arrangement by the nominal lessor.

Included among the requirements for a transaction to be a true lease under the IRS guidelines are the following:

1. The lessor must have a 20 percent minimum at risk investment in the property throughout the lease term;

2. The lessor must have a positive cash flow and a profit from the lease independent of tax benefits;

3. The lessee must not have a right to purchase the property at less than fair market value;

4. The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner; and

5. The use of the property at the end of the term of the lease by a person other than the lessor must be commercially feasible.

Reasons for change

Under the depreciation rules that existed prior to enactment of the Economic Recovery Tax Act of 1981, many corporations were in a loss position and thus unable to utilize fully the tax benefits of depreciation deductions. Deductions that could not be used in a taxable year generated a net operating loss which had to be carried back 3 years and forward 7 years. Since, in most instances, the deductions permitted under ACRS will be more accelerated than those permitted under prior law depreciation rules, the net operating losses of companies previously in a loss position would be increased and companies that previously were marginally profitable for tax purposes could be thrown into a loss position.

Although the flexibility provisions under ACRS and extension of the carryover period for net operating losses to 15 years will enable some companies to avoid loss of tax benefits, many capital intensive companies still will be unable to utilize fully their tax benefits. Moreover, even if the tax benefits can be carried over and used in later years, in present value terms the tax benefits are reduced. The leasing provisions are designed to address this issue.

II. Explanation of Provision

Overview of safe harbor provisions

The Act provides a safe harbor that guarantees a transaction will be treated as a lease, rather than a financing arrangement, even though the transaction does not comply with the Internal Revenue Service guidelines for obtaining an advance letter ruling, and even though the transaction would not otherwise be a true lease. To be eligible for the safe harbor, the following requirements must be met:

1. All parties to the agreement must elect;
2. The nominal lessor must be (a) a corporation (other than a subchapter S corporation or a personal holding company), (b) a partnership all of the partners of which are one of those corporations, or (c) a grantor trust with respect to which the grantor and all beneficiaries of the trust are corporations or a partnership comprised of corporations;
3. The lessor must have a minimum at-risk investment in the property at all times during the lease term of at least ten percent of the adjusted basis of the property;
4. The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property; and
5. The property must be "qualified leased property."

Treasury issued temporary regulations interpreting the safe harbor provisions on October 23, 1981 (46 FR 51907). Those regulations were clarified by a second set of temporary regulations on November 13, 1981 (46 FR 56048).

Factors disregarded

If a transaction meets the safe harbor requirements, the transaction will be treated as a lease entered into by the parties to the agreement and the nominal lessor will be treated as the owner for Federal tax purposes. Thus, the nominal lessor will be entitled to the associated cost recovery allowances and investment credit. The following factors will therefore not be taken into account in determining whether a transaction is a lease:

1. The fact the lessor or lessee must take the tax benefits into account in order to realize a profit or cash flow from the transaction;
2. The fact the lessee is the owner of the property for State or local law purposes (e.g., has title to the property and retains the burdens, benefits, and incidents of ownership, such as payment of taxes and maintenance charges with respect to the property);
3. The fact that no person other than the lessee may be able to use the property after the lease term;

4. The fact the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price or the fact that a rental adjustment is made upward or downward to reflect the difference between the expected residual value of the property and the actual sales price;
5. The fact the lessee, or a related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and
6. The fact the obligation of any person is subject to any contingency or offset agreement.

The new provision is a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences of a transaction. In addition, a transaction generally will not be given effect for tax purposes unless it served some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined, the transaction may not bear any resenblance to a lease.

The Treasury's temporary regulations contain examples of safe harbor leasing transactions that are permitted under the Act. One example illustrating a typical transaction assumes that corporation X acquires 5-year recovery property 10-year economic life worth $1 million, but cannot use the tax benefits. X and corporation Y agree, pursuant to the safe harbor rules, that X will transfer the property in a paper transaction to Y but X will retain all economic benefits and burdens of ownership, including title for State law purposes. Y will then lease back the property to X for nine years at which time there will be a paper transfer of the property back to X for $1. Y agrees to pay X $200,000 in cash and to give X a note for $800,000 plus interest at the market rate. In return, X agrees to pay rent in an amount exactly equal to Y's $800,000 net obligation plus interest.

Looking at the substance of the transaction between X and Y, which is cast in the form of a sale-leaseback, there has been no change of ownership and there is no business purpose for the transaction. X is still in actuality the owner and user of the property and Y has no profit from the transaction excluding tax benefits. However, since the transaction is treated as a sale to Y and leaseback to X under the safe harbor provisions, the Federal income tax law will recognize the form of the transaction producing the following economic consequences.

For Y, the present value of the tax savings due to cost recovery allowances, ITC, and interest deductions will exceed the present value of the tax on the rental income producing a return on Y's initial investment solely from tax savings. For X, the transaction results in a reduction of cost of $200,000, which is the amount of the up-front cash payment by Y.

Minimum at-risk investment

In general, the requirement that a lessor maintain a ten-percent minimum at-risk investment in the property throughout the lease term means that the lessor must have an equity investment in the property. For this purpose, an equity investment includes only consideration paid and personal liability incurred by the lessor to purchase the property other than debt to the lessee or a person related to the lessee. Contrary to the Internal Revenue Service guidelines discussed above, the minimum investment rule is determined with respect to the adjusted basis of the property rather than its original basis.

Qualified leased property

"Qualified leased property" means recovery property (other than a "rehabilitated building") which meets one of three requirements. First, "qualified leased property" includes new section 38 property (i.e., property eligible for the investment tax credit) of the lessor which is leased within three months after the property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee. The original use of the property must commence with the lessor to be new section 38 property of the lessor. The lessor may use the property within the three-month period prior to the lease.

Second, with respect to a sale-leaseback transaction, "qualified leased property" includes property that was new section 38 property when acquired by the lessee. The sale to the nominal lessor and the leaseback to the lessee (the original user) must occur within three months after the property was placed in service by the lessee, and the adjusted basis of the lessor must not exceed the adjusted basis of the lessee at the time of the lease.

For new section 38 property placed in service after December 31, 1981, and before the date of enactment of the Act (August 13, 1981), property will be considered to have met the requirement that the property be leased within three months of the date the property was placed in service if the property was leased by November 13, 1981.

Third, qualified leased property includes qualified mass commuting vehicles (as defined in section 103(b)(9), as added by the Act) financed in whole or in part by obligations the interest on which is excludable from income under section 103(a). Mass commuting vehicles qualify even though the property does not qualify for the investment credit because it is used by a tax-exempt organization or governmental unit. However, only cost recovery allowances attributable to qualified mass commuting vehicles, and not investment credit, may be transferred under a safe harbor lease.

Since, except for the special rule for mass commuting vehicles, qualified leased property must be new section 38 property, the safe harbor rule will not apply, for example, for that portion of any property used by the lessee for personal purposes, used by a governmental unit, or used by a tax-exempt organization(other than in an unrelated trade or business).

Amount and timing of deductions and credits

The Act also gives the Treasury authority to prescribe regulations necessary to carry out the purposes of the safe harbor, including (but not limited to) regulations consistent with those purposes that limit the amount and timing of deductions to the amount allowable without regard to the safe harbor rules. The Statement of Managers indicates that the conferees intended the amount and timing of cost recovery allowances in the hands of the lessor to be the same as they would have been in the hands of the lessee. As noted previously, temporary regulations interpreting these provisions have been issued.

III. ANALYSIS

Arguments for Safe-Harbor Leasing

1. Extension of ACRS benefits to businesses without current taxable income

The ACRS system provides substantial deductions and tax credits in the early years of the life of a depreciable asset, often larger than will generally be usable against taxable income from the asset itself. Thus, to utilize fully the tax incentives from ACRS, a business needs taxable income from other sources. Businesses which will not be able to utilize fully their ACRS benefits will include not only unprofitable corporations, but also profitable corporations in a wide variety of circumstances (e.g., a corporation whose capital investment is growing rapidly). It is argued that safe harbor leasing (or a comparable mechanism) is necessary to extend to corporations without such taxable income those investment incentives which are available to other corporations under ACRS.

For a business which can utilize all its ACRS benefits currently, accelerated cost recovery deductions and the investment credit provided by ACRS lower the present value of tax liability on income produced by an asset. This increases the after-tax profitability of investing in the asset and thus stimulates additional investments by the business.

However, the incentive to invest can be smaller for a business which is not taxable but expects to have taxable income beginning in the future. For this business, the after-tax profitability of currently investing in an asset is reduced by the fact that it must carry over its unused ACRS deductions and credits. One way of characterizing this situation is to say that, after taking tax benefits into account, this firm must pay more for equipment than a firm with current tax liability will pay for the identical equipment.

A safe-harbor lease can offset much of this difference in investment incentives. The money paid to the nominal lessee (here, the currently nontaxable business) plus the rent deductions retained by the lessee in a safe-harbor sale-leaseback, in effect, takes the place of ACRS tax savings. If investment incentives are the same for all firms, the allocation of investment will be more efficient.

2. Effect on the concentration of corporate assets

It is argued that a greater concentration of assets in fewer corporations would result if safe-harbor leasing (or a comparable mechanism) were not allowed.

All else being equal, a currently nontaxable business with good prospects for future profitability will accumulate greater investment credit and net operating loss carryovers due to ACRS, making it a

more attractive object for acquisition by, or merger with, a profitable business that could currently use such unused tax benefits against its own tax liability. Similarly, taxpayers with net operating loss carryforwards and investment tax credits may seek to acquire other businesses with high taxable income. Safe-harbor leasing is one mechanism for checking this accumulation of unused credits and net operating losses in currently nontaxable businesses and thereby reducing the incentives for tax-motivated mergers and acquisitions.

3. Efficiency of leasing under prior law

There was considerable leasing activity under prior law, often with the intent of enabling more companies to make effective use of their tax benefits. However, the prior law was structured so that in many cases it was impossible for the lessor to pass through to the lessee all, or a significant portion of, those tax benefits. The present rules can be viewed as a way to make the tax leasing industry more efficient and permit competition of potential lessors to cause more of the tax benefits to be passed through to the user of the equipment.

4. Administrative issues

If it is assumed that there has to be some mechanism to make ACRS benefits available to businesses who are not currently taxable, the safe-harbor leasing provides certain administrative advantages relative to alternative systems, such as refundable tax credits. For example, it is argued that lessors will have an economic interest in making certain that investments are, in fact, made before tax benefits are claimed. The government will not have to rely merely upon audit by the IRS.

Arguments Against Safe-Harbor Leasing

1. Efficiency

It is argued that safe harbor leasing is not an efficient way to extend ACRS benefits to businesses not currently taxable.

In general, the total value of any sale-leaseback transaction to all parties in the transaction is the present value of reduced tax liability purchased by the lessor. This total is allotted among the lessee (purchase money received), the brokers and lawyers involved (fees and expenses, if any) and the lessor (the present value of reduced tax liability less purchase money and fees and expenses). Thus, in order to convey $1 to the nontaxable corporation (the lessee) through safe-harbor leasing, the Treasury may have to forego more than $1 in corporate tax revenue.

The actual division of benefits between lessees and others has not been publicly disclosed, and the staff will need information about actual transactions to be able to see how efficient safe-harbor leasing is in practice.

2. Effect on perceptions of tax equity

It is argued that widespread publicity of safe-harbor leasing transactions will diminish respect for, and voluntary compliance with, income tax laws by individuals who perceive that corporations are directly buying and selling reductions in corporate tax liabilities.

3. Unintended beneficiaries

A third argument against leasing is that the benefits are availably to highly profitable taxpayers who pay little or no tax because of the operation of foreign tax credits, unrelated loss carryforwards or other tax benefits. Leasing thus gives such taxpayers a net negative effective tax rate.

4. The credit judgment of the lessor

Although leasing was presented to the committee as providing an independent credit judgment as to the advisability of making the investment in capital goods, it is unclear that lessors under the present statute are required to make such independent judgments.

IV. Revenue Impact

The safe-harbor leasing will have a substantial revenue impact. The revenue loss is expected to be $3.1 billion in fiscal year 1982, $3.6 billion in 1983, $5.1 billion in 1984, $6.7 billion in 1985 and $8.5 billion in 1986.

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APPENDIX 1

Numerical Example of Sale-Leaseback Under Present Law

Parties: Corporation X, the nominal lessee, which expects to have no income tax liability in future years
Corporation Y, the nominal lessor, which expects to have income taxable at a 46-percent rate.

Agreement

1. X purchases new equipment having a 10-year ADR life for $1 million.
2. X sells the asset to Y for $1 million. Y pays X $200,000 cash and an $800,000 note. The note is for 15 years (150 percent of ADR life) at 15 percent annual interest and is paid in equal annual installments of $136,800 (that is, a level payment loan).
3. Y leases the equipment to X for 15 years and charges an annual rental of $136,800, which exactly offsets the debt service. Thus, the only money which changes hands between X and Y is $200,000 from Y to X.
4. At the end of the lease, Y sells the equipment to X for $1.

Results

1. X purchases a $1 million asset for $800,000. (X's rental payments and receipt of loan payments do not affect cash flow--because they are offsetting--or tax liability--because X is not in a taxable position.)
2. Y purchases for $200,000 tax savings worth more than $200,000. Y's tax savings year by year are shown below. Y has deductions for depreciation (column 2) and interest paid (column 3), and it has rental income (column 4). Y's net deduction and tax change are shown in columns 5 and 6, respectively. The present value of this stream (discounted at the after-tax rate of 8.1 percent, which corresponds to a pre-tax rate of 15 percent) is $321,000. Thus, by paying $200,000 to X, Y pays $321,000 less in tax, a gain of $121,000 in constant (present) dollars.

Another way to express Y's gain is as follows. If Y had purchased at par a 15-year, 15-percent bond for $200,000, then Y would have (net of tax on interest income) $643,300 after 15 years. On the other hand, if Y invests the tax savings of column 6 at 15 percent, then Y would have (net of tax on interest income) $1,032,700 after 15 years, a gain of $389,400 in comparable (future) dollars.

Benefits and Costs of Leasing to Y
(All amounts in $1,000)

	Deductions				
End of year	Depreciation	Interest paid	Rental income	Net	Change in tax
0	150	0	0	150	-169.0*
1	220	120.0	136.8	203.2	-93.5
2	210	117.5	136.8	190.7	-87.7
3	210	114.6	136.8	187.8	-86.4
4	210	111.2	136.8	184.4	-84.8
5		107.4	136.8	-29.4	13.5
6		103.0	136.8	-33.8	15.6
7		97.9	136.8	-38.9	17.9
8		92.1	136.8	-44.7	20.6
9		85.4	136.8	-51.4	23.7
10		77.7	136.8	-59.1	27.2
11		68.8	136.8	-68.0	31.3
12		58.6	136.8	-78.2	36.0
13		46.9	136.8	-90.0	41.4
14		33.4	136.8	-103.6	47.6
15		17.9	136.8	-119.0	54.7

* Includes regular investment tax credit of $100,000. Lease is executed at end of taxable year.

APPENDIX 2

Investment Tax Credit "Strip"

There has been some discussion of whether the new safe harbor leasing provisions can be used to transfer the investment tax credit (ITC) attributable to a property without also transferring the associated cost recovery deductions through a transaction sometimes referred to as an "ITC strip." It is not clear at present whether this transaction will be permitted.

The contemplated transaction would combine the new safe harbor leasing rules with the rule of prior law (sec. 48(d)) which permits the lessor of property to pass through the ITC to the lessee (in effect treating the lessee as the owner for ITC purposes) even though the lessor remains the owner for all other tax purposes and thus cannot pass through the depreciation benefits. If the ITC strip were to be permitted, it would be accomplished by having the user of the equipment lease it in a safe harbor lease to the company which is in effect acquiring the ITC. An election under section 48(d) would be made to pass the ITC to the lessee. The lessee would then sublease the property back to the user. The sublessee/user would retain the depreciation benefits as owner/lessor and the lessee/sublessor would obtain the ITC pursuant to the section 48(d) pass-through election under the original safe harbor lease.

The ITC strip may be illustrated by the following example of a company that acquires a $1 million of equipment for use in its business. It would like to "sell" the ITC attributable to the equipment because it is currently in a tax loss position. However, it projects long-term profitability and thus would like to retain the depreciation benefits which, assuming its projections are correct, it will be able to use in the years they arise. Accordingly, it would lease the equipment to the "buyer" of the ITC under a safe harbor lease and would elect to pass the $100,000 ITC through pursuant to section 48(d). Simultaneously, the "buyer" of the ITC would sublease the property back to the loss company under terms substantially similar to those contained in the original lease. The rental payments from the ITC buyer to the loss company on the original lease would exceed the offsetting rental payments in the opposite direction under the sublease by, say, $150,000. Assuming the $150,000 excess rent is deductible at a 46 percent rate, the lessee/sublessor would have purchased the $100,000 credit for an after-tax cost of $81,000 (54 percent of $150,000).

The CHAIRMAN. Let me make just a brief statement for the record, and then there may be other members who will want to make brief statements.

This session provides an important opportunity for this committee to make a timely review of the operation of the leasing provisions. These are a large part of the business cuts in the 1981 Economic Recovery Tax Act, and the cost of these provisions is high—$27 billion over the next 5 years.

Not surprisingly, the leasing provisions have come under heavy attack. Critics assert that leasing is an inefficient means to provide benefits to business which are not currently taxable.

First, it is inefficient, the critics assert, because leasors take too large a slice of the pie in entering into leasing transactions.

Second, critics also assert that the large spread use of leasing, widely perceived as the outright purchase or sale of tax benefits, will discredit the tax system.

Third, critics assert that the leasing rules benefit companies like Occidental Petroleum, which lease rather than purchase new property because they cannot use the tax deductions and credits associated with ownership.

Fourth, critics assert that one of the principal benefits that leasing was predicted to have, self-policing and the exercise of an independent credit judgment, by the leasor as to the advisability of the investment, has proved illusory.

In reply, the Secretary of the Treasury has defended leasing as the principal means by which ACRS benefits are distributed evenhandedly and efficiently between profitable and unprofitable companies, new companies and old companies, rapidly growing and established companies.

Moreover, the Treasury tells us the use of leasing will be a safety valve for excess credits and deductions that would otherwise provide strong incentives for tax-motivated mergers and acquisitions. Again, Occidental Petroleum stands as a good example. In 1978, Occidental Petroleum made a hostile takeover bid for the Meade Corp. of Ohio. One of the major factors in that bid was said to be the need to acquire an income source to use Occidental's tax credits.

Finally, the purpose of this hearing is to review with the Finance Committee, and bring the Finance Committee up to date on the critical first 5 months of the leasing provisions, how those provisions have worked, which companies have benefited and by how much will be examined.

I can assure both critics and proponents of the leasing that we will continue to monitor this act and all other provisions of the Economic Recovery Tax Act. If this review indicates a need for public hearings, we will undertake such hearings next year.

Senator Long, do you have any comments?

Senator LONG. No, I am just pleased that you called this meeting, Mr. Chairman. I think Mr. Chapoton made a good statement on this subject that appeared in the Wall Street Journal. I have it on my desk, and I was planning to put it in the record. If you make a better one here, I will put this one in rather than that one.

I thought that Mr. Chapoton did a good job of explaining the administration's position, and I think the position of those of us who

voted for it fully understanding what this is. It may be, Mr. Chairman, that you may want to call hearings that would take a good deal more time, whenever you think it appropriate, to let the various companies that are very much affected by this measure have an opportunity to testify. But perhaps we will learn what we want to know this morning.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

This is, I think, a very important hearing because undoubtedly this provision has received a lot of attention, and much of it critical attention. I think this provision is one which frankly was put into the code without as much scrutiny as the Congress should have undertaken at the time. The White House was putting a lot of pressure on the Congress to enact the tax cuts very quickly, and it is my judgment that we perhaps acted too quickly in enacting this provision.

There is no doubt that we have to get America moving again. We have to increase the economic productive capacity of our country, and this particularly includes the industrial base of our country. There is no doubt that we in the Congress should enact provisions to help encourage industry to increase its productivity and to increase its expansion.

We are also, to some degree, a country of limited resources. The budget is only so large, therefore we have to have priorities, and there are other considerations in our economy, in addition to business expansion.

Mr. Chairman, I hope that this hearing will be the opening of a series of hearings into this question because, in my view, in all probability when all is said and done, the Congress will realize it went too far, that this provision is excessive, that we want a balanced approach to help business. We want it balanced, we don't want to be excessive. We also want more public confidence in the tax code than we now have.

I think there are several problems with the leasing provisions. One is that it just continues the American middle-income view that the big guys get all the breaks and don't have to pay any taxes, and the middle-income Americans bear the burden of the country's financial resources. This leasing provision, in my judgment, just makes that perception that much worse.

So I think there are a lot of reasons why we have to examine this, and I hope that when the hearings, and there will be several, are over that we will either repeal this provision, or that we substantially modify it so that it is more in accordance with what I think the majority of the American public wants, and that is an effort to help business in a proper balanced way.

Thank you, Mr. Chairman.

[The prepared statement of Hon. John E. Chapoton, Assistant Secretary of Tax Policy, Department of the Treasury follows:]

For Release Upon Delivery
Expected at 10:00 A.M. EST

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE SENATE FINANCE COMMITTEE
December 10, 1981

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981 (ERTA). The leasing rules have generated a great deal of confusion and misunderstanding. I am happy for the opportunity to further explain these rules and to reemphasize their role in the President's program.

Background

The "safe harbor" leasing rules of the ERTA originated in and were developed by the Office of Tax Policy in the Treasury Department. They were included in the first bipartisan tax bill (H.R. 3849) introduced on June 9, 1981. The tax package considered extensively by this Committee in June, which resulted in H.J. Res. 266, also contained the leasing provisions. Thus, these provisions were clearly and conspicuously a part of the bipartisan tax package for capital formation from its inception to its passage in August.

The leasing rules are an integral part of the President's tax program to restore economic growth. All reports up to now indicate that they are working as intended to spur investment. Every lease is associated with spending for new equipment. Much of this spending would not occur otherwise.

"Safe harbor" leases allow all companies making new investments full access to the incentives in the recent tax bill. Without these rules, unequal competition for funds would have arisen, additional financial barriers would have been presented to new companies, and additional pressures for mergers and takeovers would have been created. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

The Investment Incentives of ERTA

To see the need for the new leasing rules, the operation of the investment incentives in the recent tax bill must first be clearly understood. The principal investment incentive in the new law is provided by the Accelerated Cost Recovery System (ACRS). ACRS allows firms to deduct the cost of their investment over a much shorter time period than before. This is a valuable incentive, for when firms must postpone deducting the cost of new assets, the value of those deductions is lowered. A dollar that a corporation can deduct today is usually worth $0.46, because the tax rate is 46 percent. If the company must delay taking the $1.00 deduction for five years, however, its present value is reduced to only $0.26 for a company earning 15 percent on investments. Conversely, accelerating the deductions for expenditures on new equipment increases the value of those deductions to the firm. Accelerating deductions effectively lowers the cost of buying the equipment and raises the after-tax rate of return on that investment.

The increase in after-tax return on equipment that comes from accelerating cost-recovery deductions is the major direct investment incentive in the President's tax program. But these early deductions may occur at a time when the new machine is producing little income. Thus, the deductions will serve their purpose only if they can offset other taxable income. If a company does not have other taxable income or cannot transfer its deductions to firms that can use them, then the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up; companies with particularly large investment plans and, thus, large deductions for cost recovery; and firms with temporary domestic losses, but profitable investment opportunities. More rapid deductions for cost recovery will moderately increase the number of such currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

An Example

To see how one type of company may be excluded from the new investment incentives of ACRS, consider a new firm, Newco Manufacturing Company (Newco), making a $100,000 investment in equipment. In the first two years of that investment, Newco will be allowed under ACRS to take deductions of $37,000 and an investment credit of $10,000. To use all of these tax benefits Newco will need to have net income in those two years (before ACRS deductions) of approximately $59,000. Even highly

profitable investments generally do not return income within two years equal to more than one-half of the cost of the investment. Without income from older assets, Newco would have to postpone using some or all of the ACRS benefit, and the new tax bill would have increased Newco's after-tax return on new investment by less than that of other companies. Newco's return from that investment would be lower than that of corporations that can use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms, such as Newco, to invest in new equipment even though their investments have not yet produced large profits. Newco may allow some other firm, Taxable Corporation, which does have significant taxable income, to purchase Newco's $100,000 of new equipment for tax purposes and to lease that equipment back to Newco. This allows Newco to use the equipment in its business, but at the same time permits Taxable Corporation to take the resulting investment credit and accelerated deductions against its other income.

In this typical example, the user of the equipment (Newco, the lessee) provides financing for all but Taxable Corporation's downpayment. The terms of the agreement can be arranged so that rental payments owed by Newco to Taxable Corporation just match the reverse payments for debt service. In addition, the agreement may allow Newco to repurchase the asset at the end of the lease term for a token amount. In such a case, only the downpayment actually changes hands between the two companies. This payment is the agreed value of the tax benefits transferred by the lease.

All of the essential elements of a safe harbor lease transaction are shown in the accompanying three charts. The first chart shows the tax benefits of ACRS and the investment tax credit due to a purchase of a new machine for $100,000. These are all the investment incentives that are available from any purchase of 5-year ACRS property. No extra benefits are created by the lease.

In the second chart, we show the tax implications of a 10-year lease for a typical lessee, such as Newco. The lessee has given up the right to the investment credit and the ACRS deductions, but now has tax deductions each year for rental payments in excess of taxable interest income. Newco has, in effect, retained a share of the tax benefits associated with equipment purchases, but has stretched them out over the term of the lease. If, for example, the lessor makes a downpayment of $29,000 for the property, the lessee will have a total of $71,000 of deductions, providing tax reductions in the pattern shown in Chart II. Thus, the lease arrangement postpones the lessee's deductions until the later years when the investment will generate enough income to use the deductions.

Turning to the lessor, Chart III shows that the lessor obtains the investment tax credit and some net extra tax deductions in the early years of the lease, but also has extra net taxes due in the later years of the lease. The tax savings in the early years result from cost recovery deductions and the investment credit just as in Chart I, but these are partially offset by a series of extra tax payments through the remaining term of the lease. These extra payments occur, despite the fact that no cash changes hands, because for tax purposes the lessor is credited with taxable rental income and charged with deductible interest payments. These net tax payments of the lessor are exactly equal, every year, to the tax benefits of the lessee.

The Outcome of Leasing

There are three important aspects of such a lease which are illustrated in the charts. First, no extra deductions or tax credits are ever created. The total deductions taken by both parties are just the same as would have been taken if Newco had taxable income from other investments or if Taxable Corporation made the investment directly. They are exactly equal to the legally prescribed ACRS deductions and investment tax credit. The Treasury loses no more revenues than those necessary to provide equal investment incentives to all firms. It might also be noted that an alternative, but much less desirable way to accomplish the same result, would be by actual merger of the two companies.

The second critical point is that virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, i.e., Newco. This is because Taxable Corporation, and any other corporation interested in obtaining the investment credit and ACRS deductions, will bid for these by offering favorable lease terms. It is already apparent that the market for such deductions is becoming very competitive. The present value of the stream of tax benefits and future liabilities of the lessor, as depicted in Chart III, is about $29,000 when discounted at 15 percent. Put another way, Taxable Corporation can afford to pay up to $29,000 for this stream if the investment credit and all the deductions are expected to be usable when available, and if the interest cost of funds is no more than 15 percent.

The present value of the total of the available investment credit and ACRS deductions (Chart I) is about $45,000, not the $29,000 paid by the lessor. But this does <u>not</u> mean that Newco loses the difference between the $45,000 of foregone benefits and the $29,000 cash payment from Taxable Corporation. As noted before, Newco still has available deductions over 10 years equal to the amount of its $71,000 net cost of acquiring the property.

So long as the investment returns a sufficient profit to use these later deductions, the tax savings from them are worth $16,000 in present value terms. Thus, Newco will receive virtually the full $45,000 value of ACRS--$29,000 from Taxable Corporation and $16,000 worth of tax savings of its own.

This is a crucial result, for it means that the investment incentive inherent in ACRS has remained just where it should be--in the hands of the firm that will undertake the new investment and employ the new equipment. Although Taxable Corporation takes the credits and ACRS deductions on its tax returns, Taxable Corporation pays for those credits and accelerated deductions and pays additional taxes. Newco ultimately receives all the benefits of ACRS except transaction fees.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not encourage uneconomical or tax-motivated investment. Even with the lease agreement, Newco makes a substantial investment in the asset, $71,000 in our example, and the income that asset generates will be taxed. Unless the asset produces enough income, Newco will not be able to make a profit on its investment. Leasing does not guarantee a profit for bad investments; it merely provides the same ACRS investment incentives to firms without current taxable income as provided to firms with taxable income. With those incentives equally available, firms can select investments on the basis of their economic profitability, not on the basis of tax circumstance.

Misconceptions About Leasing

I have dwelt at some length on the details of the lease transaction because misunderstanding of these transactions is apparently the basis of much recent criticism of the safe harbor provisions. It has been said, for example, that these leases are a "bonanza" for those profitable companies able to purchase deductions and credits as "tax shelters." The opposite is proving to be the case. We have already begun to see the new rules resulting in more of the benefits passing through to users of the new equipment.

Tax-oriented leasing has been a significant feature of the economy for many years. Prior law, however, restricted and unduly complicated lease arrangements. Consequently, lease transactions required complicated agreements and legal uncertainties resulting in high transaction costs, including large legal and brokerage fees. These high costs reduced the net tax benefit (investment incentive) available to companies making an investment. The new simpler and more precise rules are resulting in lower costs and thus substantially more of the tax benefit will remain with those making the investment and less will go to compensate brokers, lessors and lawyers for taking leasing risks or attempting to avoid them.

Others have said that the new leasing rules are just another way to "bail out" loss companies. However, the fact that tax leasing will aid companies with economic losses does not detract from the desirability of the new leasing rules. These companies cannot use leases unless they undertake new investment in machinery and equipment. They will not make new investments if they do not expect them to be profitable, with or without leasing. Further, with or without leasing, the marketplace will not provide these firms with the capital to make these investments unless the marketplace also believes the investments will be profitable. There is no sound reason to penalize these firms, once they have withstood the critical analysis of lenders and investors in the free market, by forcing them to incur a higher cost of capital than their competitors. Indeed, such a penalty is singularly counterproductive. For most loss firms to become profitable, they must be able to modernize their plant and equipment. Penalizing them when they do invest only serves to make it more difficult for them to become profitable.

If tax leasing were not allowed, inefficient investment decisions would result. Otherwise-identical firms would face different capital costs depending solely on whether they had income from older assets. For example, Newco, which cannot take advantage of ACRS, might not make a particular investment even though, with the same tax incentives as other firms, that investment would be profitable to Newco and valuable to society. Alternatively, Taxable Corporation, the firm with income from older assets, might undertake the same investment rather than Newco, because of greater tax incentives. This could occur even though Taxable Corporation might lack some of the expertise to pursue the investment as efficiently as Newco. Finally, Taxable Corporation might acquire Newco so as to take advantage of Newco's unused ACRS deductions. Such tax-motivated mergers would serve no economic purpose, but would lead to a greater concentration of economic power.

Some critics have agreed with the importance of investment incentives for distressed companies, but express dismay that profitable companies are also cashing in their unusable tax benefits through leasing. Leasing by profitable companies with no current tax liability is neither surprising nor undesirable. It isn't even new. Many companies with tax losses have routinely used tax leases to make use of depreciation allowances and the investment tax credit. However, such transactions were effectively limited to equipment with a ready resale market, such as airplanes, railroad cars, and oil rigs. The new rules will end this discrimination, making leasing available for all kinds of machinery and equipment, and in the process will provide a larger share of the benefits to the equipment-using company.

A company may be currently nontaxable and yet economically profitable for a number of reasons. Our hypothetical startup company, Newco, is one example. With ACRS, rapid investment growth can result in continuing tax losses for such companies as deductions outpace current incomes. In another case, a company might have worldwide profits subject to tax abroad, but also have losses from U.S. operations resulting in excess foreign tax credits. Leasing provides the incentives of ACRS to such companies for investment in the United States. Leasing may also be of benefit to companies with capital gains income, excess depletion allowances, and perhaps other conditions that limit the current use of deductions. In every case, the same two basic principles continue to hold: (1) every lease is associated with new investment expected to be profitable and (2) no more tax benefits are available to these companies than would be provided to their currently-taxable competitors.

In any year, a disproportionate number of companies with tax losses are small businesses. While such companies may not yet have made use of the leasing provisions because information reaches them more slowly and legal fees are initially large, there is every reason to believe that a ready market for small leases will become available through local financial institutions. Again, without leasing, the potential for job-creating investment by such businesses would be reduced and the market pressure for merger or takeover by mature taxable companies would be increased.

Revenue Effects

One last point to address is the revenue cost of leasing. Before I discuss some unfounded criticisms of our revenue estimates, I want to clarify the interpretation that should be placed on the revenue cost figures. New investment in equipment must be made for leasing to take place. In calendar year 1983, additional leasing attributable to the safe harbor rules is associated with $17.3 billion of investment (see attached Table 1). We can not say for certain how much of this investment would have occurred without liberalizing the leasing rules, but we know that the leases are necessary to provide the full benefits of ACRS, the basic investment incentive in the new law. Therefore, we are convinced that the leasing rules will significantly increase the level of investment. The revenue losses from leasing are one measure of its success--direct costs to the Treasury are associated with the higher levels of investment that our economy needs.

Turning to the accuracy of our estimates, there has been a general misunderstanding which has led to press reports that Treasury underestimated the revenue impact of this provision. In fact, our original cost estimate is consistent with the high volume of leasing we are observing. We expected that the provision would be widely used and, so far, our forecast appears to be on target. The first-year revenue loss estimate is based on an estimated total of $17.8 billion of safe harbor leases in 1981. This is well within the range of press reports.

As shown in the attached table, our estimate of foregone receipts remains $29.1 billion over the six-year period, 1981-1986. This estimate is associated with $126 billion of equipment that would not have been leased in absence of the safe harbor rules. These induced leases are, however, less than half of the total dollar volume of safe harbor leases which we estimate will occur. The remainder of the observed safe harbor leasing activity consists of leasing that would have occurred anyway, under prior law or under the general provisions of ACRS. Some of those leases induced by the general provisions of ACRS would have taken the form of actual mergers rather than leasing arrangements in absence of the safe harbor rules.

To the extent that leasing activity is attributable to prior law or to the general provisions of ACRS, there is no further revenue loss to the Treasury. Revenue costs associated with this activity have already been properly included in the general level of corporate receipts. (See Table 2.)

Conclusion

Mr. Chairman, let me conclude by pointing out that this is a particularly inopportune time to talk about reducing any incentives to invest in new machinery and equipment. This investment is important for job creation in the near-term, and for productivity and economic growth in the years ahead. The safe-harbor lease provision is a market-oriented means of providing equal and effective investment incentives to all businesses.

The Administration does not favor any legislative changes in this provision. It is an efficient incentive, and according to every report, it is working very well. The new leasing rules deserve the continued support of the members of this Committee.

Attachments

Chart I

Investment Credit and ACRS Deductions

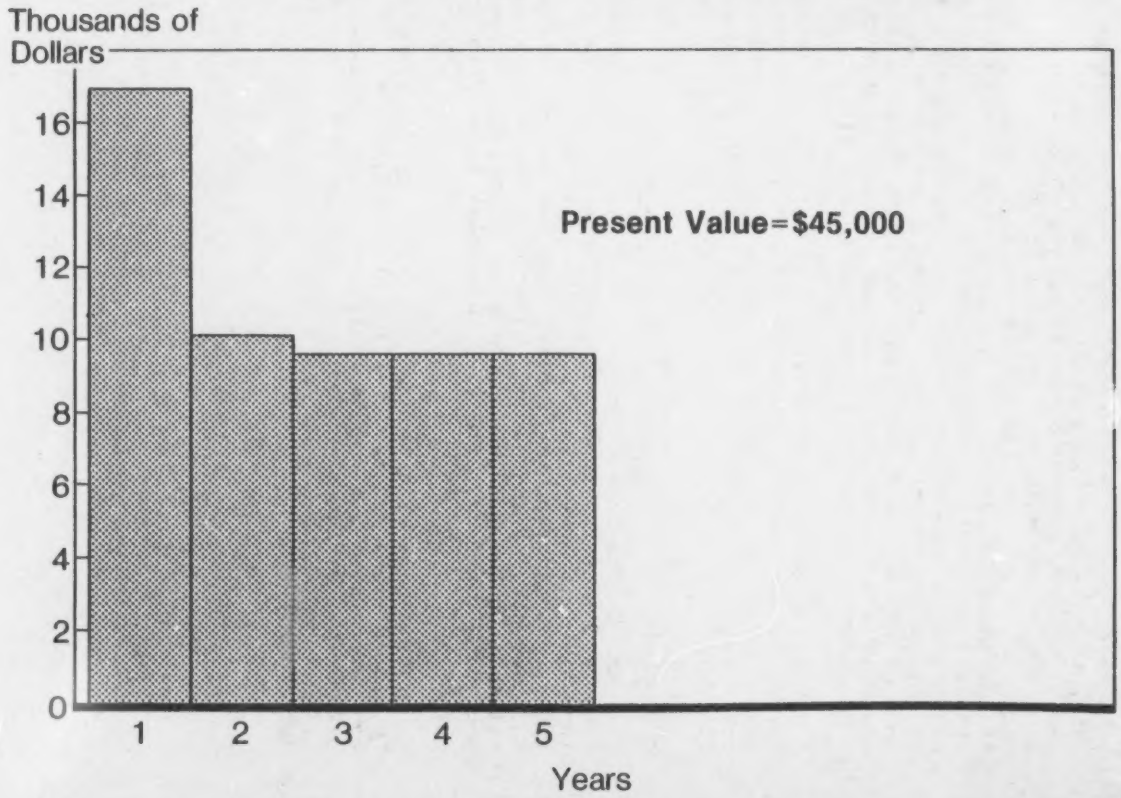

Chart II

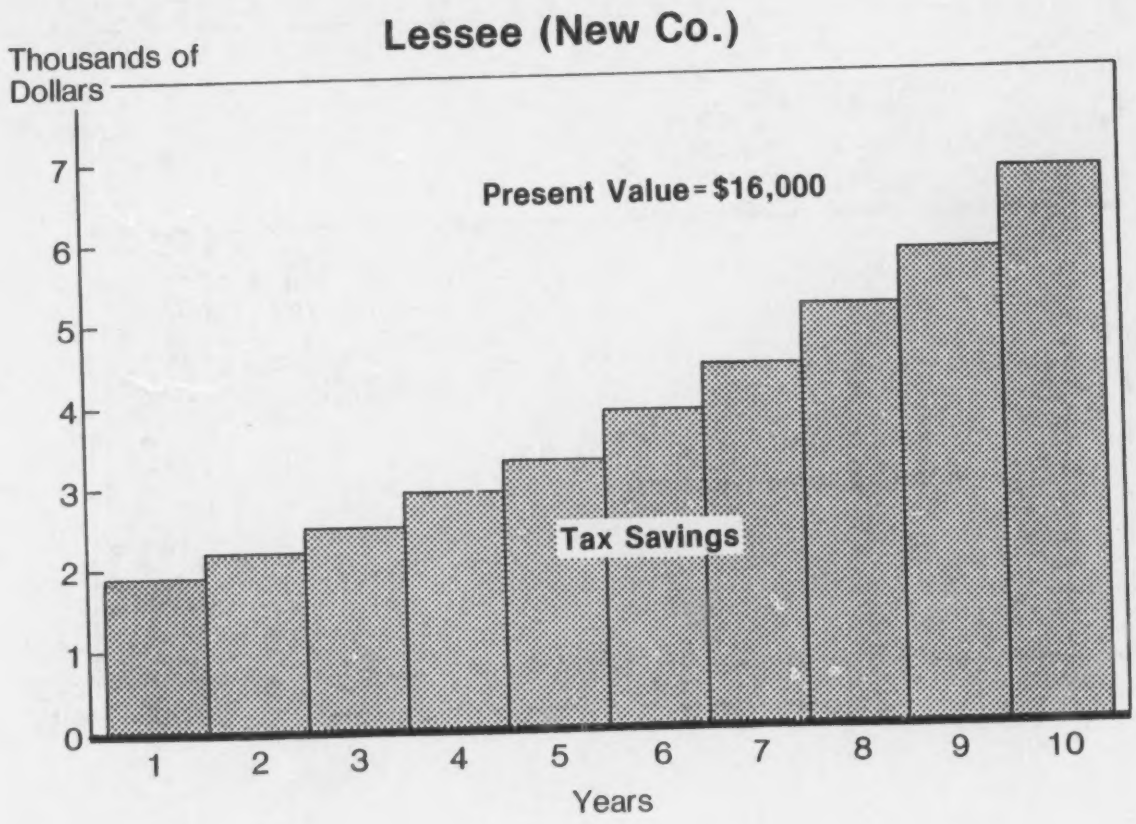
Lessee (New Co.)
Thousands of Dollars
Present Value = $16,000
Tax Savings
0
1
2
3
4
5
6
7
1
2
3
4
5
6
7
8
9
10
Years

Chart III

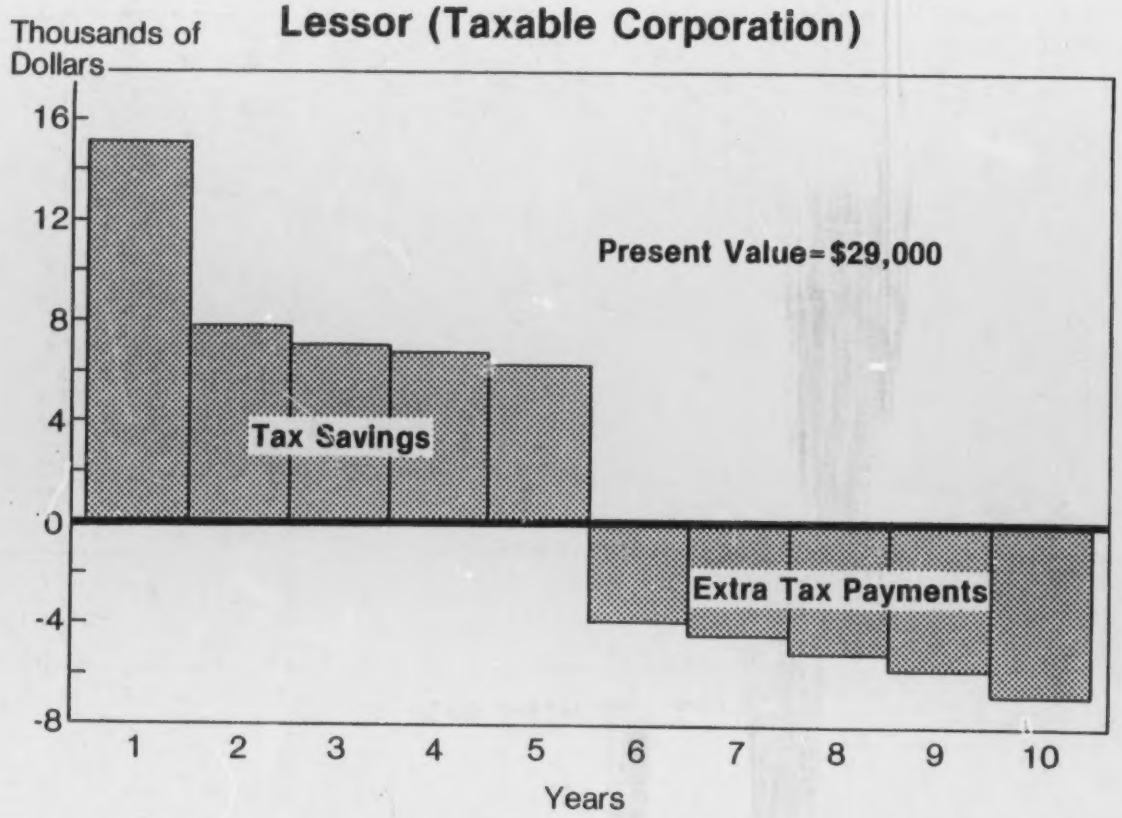
Lessor (Taxable Corporation)
Thousands of Dollars
16
12
8
4
0
-4
-8
Present Value=$29,000
Tax Savings
Extra Tax Payments
1
2
3
4
5
6
7
8
9
10
Years

Table 1

Estimates of Safe Harbor Leasing and the Loss in Receipts Attributed to the Safe Harbor Leasing Rules

($ billions)

	Years					
	1981	1982	1983	1984	1985	1986
Total value of equipment leased under the safe harbor rule.....	17.8	29.0	39.2	46.8	59.6	70.9
Less the value of equipment leased under the safe harbor rule which would have been leased under prior law.....	5.0	11.0	12.1	13.3	14.6	16.1
Less the value of equipment leased under the safe harbor rule which would have been leased under the general provisions of ACRS 1/.....	2.0	4.3	9.8	11.7	17.4	20.0
Equals the value of equipment leased under the safe harbor rule which would not have been leased under prior law or under the general provisions of ACRS.....	10.8	13.7	17.3	21.8	27.6	34.8
Loss in fiscal year receipts from incremental leasing added by the safe harbor rule....	0.5	2.7	3.8	5.4	7.3	9.4

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1981

1/ Included in these figures are investments made by nontaxable corporations which would have been merged into taxable corporations in absence of the safe harbor rule.

Table 2

Corporate Income Tax Receipts under Midsession Review Budget Economic Assumptions
With and Without the Effects of the Accelerated Cost Recovery System
and Leasing Provisions of the Economic Recovery Tax Act of 1981

($ billions)

	Fiscal Years						
	1980	1981	1982	1983	1984	1985	1986
Corporate income tax receipts under 1980 law	64.6	64.9	72.6	84.4	97.2	109.1	122.9
Economic Recovery Tax Act of 1981:							
Accelerated cost recovery system	--	-1.3	-4.6	-10.2	-17.8	-27.2	-42.2
Leasing	--	-0.5	-2.7	-3.8	-5.4	-7.3	-9.4
Other	--	*	-0.3	0.5	-0.6	-2.3	-2.6
Total	--	-1.8	-7.6	-13.5	-23.9	-36.8	-54.2
Corporate income tax receipts under current law	64.6	63.0	65.0	71.0	73.3	72.3	68.7

Office of the Secretary of the Treasury
Office of Tax Analysis

December 9, 1981

*Less than $50 million.

Note: Details may not add to totals due to rounding.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. I am anxious to hear from the Secretary. I think I share the view that Senator Long has already expressed. I would like to go ahead with the hearing.

The CHAIRMAN. Thank you, Senator Symms.

I would like to mention to Senator Baucus and others, that I believe we have a responsibility to find excesses or abuses in the Economic Recovery Tax Act, if they exist and examine them.

However, at the same time, I do not believe we should be panicked by the news media who, in my opinion, has not studied this issue in depth.

Mr. Chapoton.

STATEMENT OF JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHAPOTON. Thank you, Mr. Chairman.

I might just comment at the outset that we, too, Senator Baucus, think that the perception is quite important, and that is why we welcome these hearings. We think it does deserve full explanation, and we think that when it is better understood, the perception problems will dissipate.

Mr. Chairman, I would also like to introduce J. Gregory Ballentine, who is Deputy Assistant Secretary for Tax Analysis, and who is very familiar with the economic analysis behind this provision.

The CHAIRMAN. Could I ask before you start, can the people in the back hear?

If you would pull the mike a little bit closer, Mr. Chapoton, because there seems to be some interest in this matter. [General laughter.]

Mr. CHAPOTON. I am pleased to be here today, Mr. Chairman, to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981. These leasing rules have generated a great deal of confusion and misunderstanding. I am happy to have the opportunity to further explain these rules and to emphasize their role in the President's program.

The safe harbor of the Economic Recovery Tax Act originated and was developed by the Office of Tax Policy in the Treasury Department. They were included in the first bipartisan tax bill, H.R. 3849, introduced in the House on June 9, 1981. The tax package considered extensively by this committee in June, which resulted in the tax bill reported out by the Senate Finance Committee on July 6, also contained leasing provisions. Thus, these provisions were clearly and conspicuously a part of the bipartisan tax package for capital formation from its inception to its passage in August.

The leasing rules are an integral part of the President's program to restore economic growth. All reports up to now indicate that they are working as intended to spur investment. Every lease is associated with spending for new equipment. Much of the spending would not occur otherwise.

Safe harbor leases allow all companies making new investment full access to the incentives in the recent tax bill. Without these rules unequal competition for funds would arise, additional finan-

cial barriers would be presented to new companies, and additional pressure for mergers and takeovers would be created.

The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

To see the need for the new leasing rule, the operation of the investment incentives in the recent tax bill must first be clearly understood. The principal investment incentive in the new law is provided by the accelerated cost recovery system [ACRS]. ACRS allows firms to deduct the cost of their investment over a much shorter period of time than before. This is a valuable incentive, for when firms must postpone deducting the cost of new assets, the value of those deductions is lowered.

For example, a dollar that a corporation can deduct today is usually worth 46 cents because we have a maximum corporate tax rate of 46 percent. If the company must delay taking the $1 deduction for 5 years, its present value is reduced to only 26 cents for a company earning 15 percent on investment, or with an internal rate of return of 15 percent.

Conversely, accelerating the deductions for expenditures on new equipment increases the value of those deductions to the firm. Accelerating deductions effectively lowers the cost of buying the equipment and raises the aftertax rate of return on that investment.

The increase in aftertax return on equipment that comes from accelerating cost-recovery deductions is the major direct investment incentive in the President's tax program. But these early deductions may occur at a time when the new machine is producing little income. Thus, the deductions will serve their purpose only if they can offset other taxable income.

If a company does not have other taxable income, or cannot transfer its deductions to firms that can use them, then the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up, companies with particularly large investment plans, and thus large deductions from cost recovery, and firms with temporary domestic losses but profitable investment opportunities.

More rapid deductions for cost recovery will moderately increase the number of such currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

To see how one type of company might be excluded from the new investment incentives of ACRS, consider a new firm, which we call Newco Manufacturing Co., which is making a $100,000 investment in new equipment. In the first 2 years of that investment, Newco will be allowed under ACRS to take deductions of $37,000 and an investment credit of $10,000. To use all of these tax benefits Newco will need to have net income in those 2 years, before ACRS deductions, of approximately $59,000. That is, it will have to have net taxable income, ignoring ACRS deductions, of $59,000, if the investment were $100,000.

Even highly profitable investments generally do not return income within 2 years equal to more than one-half of the cost of the investment. Without income from older assets, Newco would have to postpone using some or all of the ACRS benefit, and the new tax bill would have increased Newco's aftertax return on new investment by less than that of other companies. Newco's return from that investment would be lower than that of corporations that can use all of the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms such as Newco to invest in new equipment even though their investments have not yet produced large profits. Newco may allow some other firm, which we call Taxable Corp.—the buying firm in our example—which does have significant taxable income to purchase Newco's $100,000 of new equipment for tax purposes, and to lease that equipment back to Newco.

This allows Newco to use the equipment in its business, but at the same time it permits Taxable Corp. to take the resulting investment credit and accelerated deductions against its other income.

In this typical example, the user of the equipment, Newco, the lessee, provides financing for all but Taxable Corp.'s downpayment. The terms of the agreement can be arranged so that the rental payments owed by Newco to Taxable Corp. just match the reverse payments for that service.

That is, the rental payments from Newco to Taxable Corp. are dollar for dollar equal to the debt service payments from Taxable Corp. to Newco, the note that Taxable Corp. gives Newco in the purchase of the equipment.

In addition, the agreement may allow Newco to repurchase the asset at the end of the lease term for a token amount. In such a case, only the downpayment from Taxable Corp. to Newco actually changes hands between the two companies. The other payments, the rental payment and the debt service payments, can completely offset each other, so that only the downpayment will actually change hands. This is the payment that the parties have agreed on as the value of the tax benefit transferred by the lease.

All of the essential elements of a safe harbor lease transaction are shown in the charts accompanying the statement, Mr. Chairman.

The CHAIRMAN. We have the charts.

Mr. CHAPOTON. We have a chart here that I might put up.

The CHAIRMAN. If someone could point out on the chart.

Mr. CHAPOTON. Let me describe it. The gold chart, and the first chart attached to the statement, show the tax benefits of ACRS and the investment tax credit from $100,000 of investment in a new machine. This is 5-year ACRS property. The charts show the tax benefits from that investment.

Obviously, the first year has the largest tax benefit because the investment tax credit is given in that year. The chart is depicted in terms of tax amounts. In the second year, there are considerably less, but still significant, tax benefits. Then the tax benefits level out in years three, four, and five, and cease after year five even though the property will generally still be in service.

Keep in mind that these are the tax benefits under ACRS, and that no extra benefits are created under a leasing arrangement.

In the second chart, the one in red as shown here, the implications of a 10-year lease covering this 5-year ACRS property are shown for a typical lessee such as Newco in our example.

The lessee has given up the right to the investment credit and the ACRS deductions, but now has deductions each year for rental payments in excess of taxable interest income. Keep in mind that Newco is paying rental to Taxable Corp., the lessor, for the use of the equipment, and the rental payment gives Newco a rental deduction.

That rental deduction is offset by the payments from the lessor, from Taxable Corp. to Newco because Taxable Corp. purchased the property and had to give Newco a note for the purchase price, and the interest payment on that note offsets the rental deduction to Newco.

Newco has, in effect, retained a share of the tax benefit associated with the equipment purchased, but it stretched them over the term of the lease. So you can see that Newco's deductions start out low and go high, that is the red. We are still in the red chart there.

In our example, the lessor, Taxable Corp., makes a downpayment of $29,000 for this $100,000 piece of property, and gives a note for $71,000 bearing interest at 15 percent. The lessee, Newco, will have a total of $71,000 of deductions in the pattern shown on the second chart, that is, small tax reductions in the early years and large tax deductions in the later years.

Thus, the lease arrangement postpones the lessee's deductions until the later years when the investment will generate enough income to use the deductions. Keep in mind that it is important that Taxable Corp. is giving a note to Newco for its purchase of the equipment. The note, like a home mortgage note, is a level payment note, so it has large interest payments in the early years and small interest payments in the later years. Newco will have a deduction for the rental payments it pays to Taxable Corp. in the early years offset by large interest income in the early years, showing small benefits to Newco, and large tax benefits in the later years.

Chart III, which is the blue chart, the bottom chart in the big set of charts, shows that the lessor obtains the investment credit and some net extra tax deductions in the early years of the lease, but also has net extra taxes due in the later years of the lease.

The amount above the line in the blue chart, in years 1 through 5, show the net tax savings to the lessor, Taxable Corp., who has bought the tax benefits; that corporation has net tax savings in years 1 through 5, but net tax liability from the transaction in years 6 through 10.

The CHAIRMAN. You are talking about the blue chart?

Mr. CHAPOTON. Yes, sir.

The CHAIRMAN. In the first 5 years there is a saving, and in the years 6 through 10, they pay an additional tax.

Mr. CHAPOTON. In the years 6 through 10, the purchaser pays additional tax.

The CHAIRMAN. Is that an offset?

Mr. CHAPOTON. The benefit to Taxable Corp. is the timing differential principally. He gets the deductions in the early years, and pays the additional tax in the later years. That is the nature of our ACRS system in general.

The CHAIRMAN. The purchaser needs the tax deductions in the early years. In your example, Newco receives for those benefits a reduction in the cost of the equipment in the early years, when the new company needs the benefits.

Mr. CHAPOTON. That is when the benefits are needed in the early years. That is the nature of accelerated cost recovery deductions. You get larger deductions in earlier years, but that is offset by increased taxable income in later years.

The instructive element of these three charts taken together is that charts II and III, the blue and the red, when added together equal chart I. Going through this a little bit slower, taking years 1 through 5 we can see in the first chart the benefits are very significant. In the second chart, there are still benefits, that is to Newco, and they are small benefits in the early years. Then we go to Taxable Corp., the blue chart, where there are large benefits. When you add the blue and the red together, they equal the gold. The gold is the maximum benefit that is obtained without leasing under ACRS.

I recognize, Mr. Chairman, that it is a complicated transaction, and does take some time to see what happens, but it is a typical financial arrangement. The principal point I want to reiterate is that the maximum benefits under ACRS without regard to leasing are specified in the first chart. The gold, the other two charts, when added together, equal the first chart.

Stated differently, in the years 6 through 10, the tax detriment in the blue, the tax detriment to the buyer of the benefit, is exactly the same as the tax benefit, in years 6 through 10 to the Newco Corp., the red chart there.

There are three important aspects of such a lease which are illustrated in these charts. First, no extra deductions or tax credits are ever created. That is the point I have just been making.

The total deductions taken by both parties are just the same as would have been taken if Newco had taxable income from other investment, or if Taxable Corp. made the investment directly.

They are exactly equal to the legally prescribed ACRS deductions and investment tax credit. The Treasury loses no more revenue than those necessary to provide equal investment incentive to all firms.

It might also be noted that an alternative, but a much less desirable way to accomplish exactly the same result, would be actual merger of these two companies. A merger would be combining the blue and the red, the bottom two charts, and you would have the same results. Of course, this would be a tax motivated type merger, which we think should not be an incentive of the tax law.

The second critical point is that virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, Newco in our example. This is because Taxable Corp., and any other corporation interested in obtaining the investment credit and the ACRS deductions, will bid for these by offering favorable lease terms.

It is already apparent that the market for such deductions is becoming very competitive. The present value of the stream of tax benefits and future liabilities of the lessor, as depicted in chart III, is about $29,000 when discounted at 15 percent.

I think that this is worth restating. The present value shown on that chart of all the future tax benefits are worth about $29,000 from a $100,000 investment when using a 15 percent discount rate.

Put another way, Taxable Corp. can pay up to $29,000 for this stream if the investment credit and all the deductions are expected to be usable when available, and if the interest cost of such funds to Taxable Corp. is no more than 15 percent.

The present value of the total of the available investment credit and ACRS deductions, which is chart I, is about $45,000, not the $29,000 paid by the lessor. But this does not mean that Newco loses the difference between the $45,000 of the ultimate tax benefits, and the $29,000 cash payment from Taxable Corp. As noted before, Newco still has available deductions over 10 years equal to the amount of $71,000, the net cost of acquiring the property.

So long as the investment returns a sufficient profit to use these later deductions, the tax savings from them are worth $16,000 to Newco in present value terms. Thus, Newco will receive virtually the full $45,000 value of ACRS, $29,000 from Taxable Corp., and $16,000 worth of tax savings on its own.

This is a crucial result, for it means that the tax incentive inherent in ACRS has remained just where it should be, in the hands of the firm that will undertake the new investment and employ the new equipment. Although Taxable Corp. takes the credits and ACRS deductions on its tax return, Taxable Corp. pays for those credits and accelerated deductions, and pays additional taxes in later years of the lease, as shown in the blue chart in years 6 through 10. Newco ultimately receives all of the benefits of ACRS, except transaction fees.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not encourage uneconomical or tax motivated investment.

Even with the lease agreement, Newco, in our example, makes substantial investment in the asset, $71,000. The income that asset generates will be taxed. Unless the asset produces enough income, Newco will not be able to make a profit on its investment.

Leasing does not guarantee a profit for a bad investment. It merely provides the same ACRS investment incentives to firms without current taxable income as provided to firms with taxable income. With those incentives equally available, firms can select the investments on the basis of their economic profitability, not on the basis of tax circumstance.

I have dwelt at some length on the details of the lease transaction because misunderstanding of these transactions is apparently the basis of much of the recent criticism of the "safe harbor" provisions. It has been said, for example, that these leases are a bonanza for those profitable companies able to purchase deductions and credits as tax shelters. The opposite is proving to be the case. We have already begun to see the new rules resulting in more of the benefits passing through to users of the new equipment.

Tax-oriented leasing has been a significant feature of the economy for many years. Prior law, however, restricted and unduly complicated lease transactions. Consequently, lease transactions required complicated agreements and legal uncertainties resulting in high transaction costs, including large legal and brokerage fees.

These high costs reduced the net tax benefit, the investment incentive, available to companies making an investment. The new simpler and more precise rules are resulting in lower costs, and thus substantially more of the tax benefit will remain with those making the investment, and less will go to compensate brokers, lessors, and lawyers for taking leasing risks or attempting to avoid them.

Others have said that the new leasing rules are just another way to bail out loss companies. However, the fact that tax leasing will aid companies with economic losses too does not detract from the desirability of the new leasing rules.

These companies cannot use leases unless they undertake new investments in machinery and equipment. They will not make new investments if they do not expect them to be profitable with or without leasing. Furthermore, with or without leasing, the marketplace will not provide these funds with the capital to make these investments unless the marketplace also believes the investments will be profitable.

There is no sound reason to penalize these firms once they have withstood the critical analysis of lenders and investors in the free market by forcing them to incur a higher cost of capital than their competitors. Indeed, such a penalty is singularly counterproductive.

For most loss firms to become profitable, they must be able to modernize their plant and equipment. To penalize them when they do invest only serves to make it more difficult for them to become profitable.

If tax leasing were not allowed, inefficient investment decisions would result. Otherwise identical firms would face different capital costs depending solely on whether they had income from older assets. For example, Newco, which cannot take advantage of ACRS, might not make a particular investment even though, with the same tax incentives as other firms, that investment would be profitable to Newco and valuable to society.

Alternatively, Taxable Corp., the firm with income from older assets, might undertake the same investment rather than Newco because of greater tax incentives. This could occur even though Taxable Corp. might lack some of the expertise to pursue the investment as efficiently as Newco.

Finally, Taxable Corp. might acquire Newco so as to take advantage of Newco's unused ACRS deductions. Such tax motivated mergers would serve no economic purpose, but would lead to a greater concentration of economic power.

Some critics have agreed with the importance of investment incentives for distressed companies, but express dismay that profitable companies are also cashing in their usable tax benefits through leasing. Leasing by profitable companies with no current tax liability is neither surprising nor undesirable. It is not even new.

Many companies with tax losses have routinely used tax leases to make use of depreciation allowances and the investment tax credit. However, such transactions were effectively limited to equipment with a ready resale market, such as airplanes, railroad cars, and oil rigs.

The new rules will end this discrimination, making leasing available for all kinds of machinery and equipment, and in the process will provide a larger share of the benefits to the equipment-using company.

A company may be currently nontaxable and yet economically profitable for a number of reasons. Our hypothetical start-up company, Newco, is one example. With ACRS, rapid investment growth can result in continuing tax losses for such companies as deductions outpace current incomes.

In another case, a company might have worldwide profits subject to tax abroad, but also might have losses from U.S. operations resulting in excess foreign tax credits. Leasing provides the incentive of ACRS to such companies for investment in the United States.

Leasing may also be of benefit to companies with capital gains income, excess depletion allowances, and perhaps other conditions that limit the current use of deductions.

In every case, the same two basic principles continue to hold: Every lease is associated with new investment expected to be profitable, and no more tax benefits are available to these companies than would be provided to their currently taxable competitors.

In any year, a disproportionate number of companies with tax losses are small businesses. While such companies may not yet have made use of the leasing provisions because information reaches them more slowly and legal fees are likely to be unusually large, there is every reason to believe that a ready market for small businesses will become available through local financial institutions. Again, without leasing, the potential for job-creating investment by such businesses would be reduced and the market pressure for merger and takeover by mature taxable companies would be increased.

One last point to address is the revenue cost of leasing. Before I discuss some of the unfounded criticisms of our revenue estimates, I want to clarify the interpretation that should be placed on the revenue cost figures.

New investment in equipment must be made for leasing to take place. In calendar year 1983, additional leasing attributable to the safe harbor rules is associated with $17.3 billion of investment. This is shown on table 1, which is the second to the last page of my statement, Mr. Chairman. It might be well in a moment to go through that table, but I will not do so right now.

We cannot say for certain how much of the investment would have occurred without liberalizing the leasing rules, but we know that leases are necessary to provide the full benefits of ACRS, the basic investment incentive in the new law. Therefore, we are convinced that the leasing rules will significantly increase the level of investment. The revenue losses from leasing are one measure of its success. Direct cost to the Treasury are associated with the higher levels of investment that our economy needs.

Turning to the accuracy of our estimates, there has been a general misunderstanding which has led to press reports that Treasury underestimated the revenue impact of this provision. In fact, our original cost estimate is consistent with the high volume of leasing we are observing.

We expected that the provision would be widely used, and so far our forecast appears to be on target. The first year of revenue loss estimate is based on an estimated total of $17.8 billion of safe harbor leases in 1981. This is well within the range of press reports.

As shown in table 2, which is attached, our estimate of foregone receipts remains $29.1 billion over the 6-year period, 1981–86. This estimate is associated with $126 billion of equipment that would not have been leased in the absence of the safe harbor rule. These induced leases are, however, less than half of the total dollar volume of safe harbor leases which we estimate will occur.

The remainder of the observed safe harbor leasing activity consists of leasing that would have occurred anyway under prior law, or under the general provisions of ACRS. Some of those leases induced by the general provisions of ACRS would have taken the form of actual mergers rather than leasing arrangements in the absence of the safe harbor leasing rules.

To the extent that leasing activity is attributable to prior law or to the general provisions of ACRS, there is no further revenue loss to the Treasury. Revenue costs associated with this activity have already been properly included in the general level of corporate receipts.

For the Committee's information, although you have seen these figures before, we have attached this table 2, the last table in our testimony, with the level of corporate receipts before ACRS and the Economic Recovery Tax Act, and the level of the corporate receipts after taking into account the effect of the Economic Recovery Tax Act and ACRS.

We split out leasing and the other rather minor changes in corporate tax receipts, showing the net corporate tax receipts after all of the reductions in corporate tax receipts by the Economic Recovery Tax Act.

Mr. Chairman, let me conclude by pointing out that this is a particularly inopportune time to talk about reducing any incentive to invest in new machinery and equipment. This investment is important for job creation in the near term and for productivity and economic growth in the years ahead. The safe-harbor lease provision is a market-oriented means of providing equal and effective investment incentives to all businesses.

The administration does not favor any legislative changes in this provision. It is an efficient incentive and, according to every report, it is working very well. The new leasing rules deserve the continued support of the members of this committee.

Mr. Chairman, that concludes our written formal statement, and we will be happy to answer any questions that you might have.

The CHAIRMAN. Thank you, Mr. Chapoton.

We will proceed under the early-bird rule, and I would like to ask just a few questions. I may have to leave at about 11 because

we have the farm bill conference on the floor, which is of some interest to some of us.

So we meet the issue head on, I will put to you the direct questions that have been put to us when people complain about this program.

Isn't the 10-percent minimum investment requirement largely meaningless because under the Treasury regulations, the lessor can promptly recover his 10-percent investment through the receipt of a 10-percent investment tax credit on the leased property?

Mr. CHAPOTON. The 10 percent does mean that the lessor has to come up with capital at the outset. It is true that it will be recovered immediately just as capital investment under the old leasing rules would have been recovered very quickly. It does not have a dramatic impact, but it does mean that dollars have to go up at the front end by the lessor, and we thought that desirable.

The CHAIRMAN. Do you think that 10 percent, as currently construed, is adequate?

Mr. CHAPOTON. Yes, sir, we do think that it is adequate. If more is required to be put up, the economics of the transaction would be changed, and can be changed rather dramatically if the front-end investment is increased.

The CHAIRMAN. I think another question is, what percent benefits go to the middlemen, the people who arrange these transactions?

Is it better to have refundability? Why leasing? Why not refundability as proposed by Senators Long, Heinz, and Kennedy?

Mr. CHAPOTON. Refundability was urged at some point throughout the consideration of the tax bill. All the proponents of refundability discussed only the credit, that is, the investment tax credit. We thought that if the benefits that might be lost to companies that don't have current tax liability were a problem, it is not a problem just with credit. Indeed, as we can see, the ACRS benefits, the deductions themselves, are very important. So we wanted to cover both.

It would be possible, perhaps, to design a refundability type system that would refund both, but it would be very complicated. More importantly, through leasing, a party other than the Government has to police the transaction, has to make sure the equipment does in fact exist, and has to run the risk that if the equipment does not continue to be used in this country, does not continue to be used within our general rules applicable to ACRS, then the benefits would in fact be recaptured.

So the lessor, or someone on behalf of the lessor, has the burden of making sure the property exists, putting up the additional 10 percent, as you mentioned, and making sure that the property continues to be used in accordance with the tax rules, so that the benefits will not be lost.

The CHAIRMAN. Do you have any idea—perhaps it is too early, and you may know better next year—what percent of the benefits of safe harbor leasing is going to middlemen?

Mr. CHAPOTON. The percent is going down. We know the percent the middleman charged was much higher under the old leasing rules. We know that the transaction costs, which is what we are talking about, in the early days under the new leasing rules cer-

tainly were higher while parties were getting accustomed to what the rules specifically are, and preparing documentation for implementing these transactions.

We are seeing the transaction costs decrease dramatically, and we expect much greater decreases in transaction costs as these occur. All the information we know so far is what we can see about transactions, but we are seeing transaction costs decrease to a very low percentage of the benefits that are flowing to the user of the equipment.

The CHAIRMAN. Do you have any idea of the percentage?

Mr. CHAPOTON. In the 1-percent range.

The CHAIRMAN. It is my understanding that your regulations have special rules that allow the buyer of tax benefits to avoid recapture if the seller goes bankrupt; is that true?

Mr. CHAPOTON. That is correct. As I stated earlier, the lessor does have to be concerned about recapture if the property does not continue to be used as the parties intended. The general arrangement between parties will be that if the lessee, in fact, makes unauthorized use of the property, the lessor has to recapture the tax benefits, and an amount would be due from the lessee to the lessor.

In the case of bankruptcy or other court action, which might cause the property to be used in a manner that is not intended or to be transferred to a party who does not agree to abide by the terms of the lease, the lessor could not protect itself in advance.

So what the bankruptcy provisions in the regulations state is that if all secured creditors agree, and if proper notice is given to make sure that any party who acquires the property from the trustee in bankruptcy is not entitled to the benefits, then recapture does not occur. At the same time, any party who acquires that property in the bankruptcy proceeding will not be entitled to the ACRS benefits, and will have to, in effect, step in the shoes of the lessee.

The CHAIRMAN. It is my understanding that the established leasing industry is less than enthusiastic about this new provision. In fact, some have been suggesting the provision should be repealed. That can be construed in a couple of ways. One, it must be pretty good and working so efficiently that it is reducing their profits, or they would not ask for it to be repealed; or, second, that it is not working at all.

How do you view the attitude of the existing leasing companies?

Mr. CHAPOTON. We have heard that to some extent, Mr. Chairman. Every complaint that we have discussed clearly shows that the transaction costs are decreasing. Some companies that were involved in the leasing industry, which was a major industry before 1981, have had their profits decline from leasing transactions because the transactions costs are going down. Another way of stating it is, this is working correctly.

In addition, under prior leasing rules, the lessor was entitled to the full ownership of the property at the end of the term of the lease, and if the lessee wanted to get the property back, he had to pay full fair market value for the property at that time. This residual value is denied the lessor under the safe harbor leasing rules, so that all of those benefits go to the lessee, the user of the property.

The CHAIRMAN. Can you tell me the origination of this proposal. I have read that a group of lobbyists got together and came up with a brilliant idea—I don't suggest that they don't have a lot of brilliant ideas—and sold it to Treasury. What is the genesis of the leasing provisions?

Mr. CHAPOTON. Mr. Chairman, in early February we began analyzing depreciation provisions. Several had been presented. We decided upon ACRS as the one we thought would best serve the purposes of the President's package.

At that time, before and after the presentation of the February 18 package, we were concerned about the nontaxable companies, the growth in tax benefits that could not be used, the additional pressure that it would put on the existing leasing rules and all of the problems in the existing old law leasing rules, and the additional pressure it would put on tax motivated mergers.

We decided at that time that February 18 ACRS proposal could be substantially improved with some type of lease provision in it. We developed leasing rules in the office. We worked for a great deal of time on them. After that, parties came in, as I mentioned earlier, suggesting a refundability of the credit, but no one suggested the leasing provisions that we developed.

We presented them on June 9 in the Conable-Hance bill that was introduced in the House. This was the first time they were released in detail. As you may remember, the next day we appeared before this committee on June 10. At that time, we reduced some of the ACRS benefits to pay the additional cost of the leasing provisions as we had included them in our proposal.

The CHAIRMAN. They came from Treasury, then; is that correct?

Mr. CHAPOTON. They did come solely from Treasury. We had worked on them for several months.

Senator BYRD. Would the chairman yield for a question?

The CHAIRMAN. I will be happy to.

Senator BYRD. Am I correct in gathering from what you say that this was not a part of the President's original recommendation.

Mr. CHAPOTON. That is correct.

Senator BYRD. Thank you.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chapoton, I want to follow up a question of Senator Dole's. I understand that you cannot precisely state every dollar that the Treasury loses in one of these arrangements. What percentage allocation is among the lessee, the lessor, the middleman, and all the parties that are involved? I wonder if you could break that down?

Mr. CHAPOTON. Let me answer this more generally first of all. Virtually all of the benefits of the lease to the lessee—that is the amount paid by the acquiring party—$29,000 in this example—plus the benefits retained by the lessee—almost equal the present value of the tax benefits to the user of the equipment before the lease.

So all of the benefit flows to the lessee, other than transactions costs. We are seeing transaction costs of about 1 percent.

Senator BAUCUS. So what you are saying is that for every dollar the Treasury loses, only one cent of every dollar goes to somebody other than the lessee?

Mr. CHAPOTON. No, I am not saying that.

Senator BAUCUS. What are you saying, then?

Mr. CHAPOTON. I am saying that the dollar goes where we want it to go. The actual tax deductions, because he has paid for them, will go to the lessor. So if you are tracing actual tax deductions, the lessor, the buyer, will pay a dollar today for tax benefits which will yield, if we assume a 15-percent rate of return, $1.15 a year from today.

If he is investing at a 15-percent rate of return, he will pay a dollar to the lessee for that benefit. The lessee, obviously, ends up with a dollar. The lessee's present value of that benefit is also a dollar. So the dollar transfers from the lessor to the lessee. We have the dollar where we want it, and the lessor paid for it. The lessor's profit is the 15-percent return from the date he pays for it to the date the tax benefit is realized.

You get $1.15 tax benefit for a dollar paid, and that represents a 15-percent rate of return to the lessor, but it does not represent any further loss to the lessee.

Senator BAUCUS. Let me ask the question again just so I fully understand it, because I must confess I don't.

For every dollar that the Treasury loses because of ACRS here, I am trying to determine over a 10-year period, that is assuming that the asset that you have in mind here will last 10 years because it is difficult to be specific on this, what percentage or what portion of the economic benefit due to the tax provisions here will accrue to the lessee, what portion to the lessor, and what portion to brokers, middlemen, or any other party that may be directly or indirectly associated with this transaction?

Mr. CHAPOTON. To the extent the transactions are efficient, all of the dollars lost to the U.S. Treasury, all of that benefit goes to the user/lessee, save only transaction costs.

Senator BAUCUS. You are saying that the only incentive, therefore, for a lessor to get into this is to gain some sort of transaction cost?

Mr. CHAPOTON. No, that is not it.

Senator BAUCUS. What is the incentive for the lessor to get into this, since he gets no economic benefit?

Mr. CHAPOTON. He has a rate of return. I think the point is a very valid point, and it is a rather difficult one.

Let's take just Newco, the user of the equipment, which is going to get a dollar of deduction a year from now. That deduction to him will have a tax benefit of a dollar a year from now. Let's say that he uses a 15-percent discount rate, and it is worth 85 cents to him. If he sells that future tax benefit now for 85 cents, he has gotten full benefit for that future dollar of tax benefit.

If the buyer pays 85 cents for it he has paid 85 cents for a tax benefit, and he will get $1 a year from today. He has made 15 percent, or a little more, on his investment. The fact that he makes a return on his investment does not mean that the benefits do not flow to the lessee. The only slippage will be the transaction costs.

Senator BAUCUS. How closely are you monitoring parties involved in these kinds of transactions, that is the amount of tax deduction claimed by the lessor in these situations? What I am really

asking is, how closely are you following these economic arrangements? How good is your data?

Mr. CHAPOTON. We have no data on actual transactions to date because that will come on tax returns.

Senator BAUCUS. If you have no data, how can you be so sure as to where the economic benefit is going to accrue?

Mr. CHAPOTON. We have examined specific transactions.

Senator BAUCUS. You say you have no data. I don't mean to be critical.

Mr. CHAPOTON. I understand.

Senator BAUCUS. I am just trying to figure out the degree to which you can be secure and confident in your judgments based upon what seems to be fairly sketchy information.

Mr. CHAPOTON. This analysis was made before we came forward with the provision. We saw where these benefits would flow. We can look at a transaction involving a $100,000 investment, and we can see if $29,000 is paid by the lessor to the lessee. The only facts we have to know to bear that out are those two facts.

Senator BAUCUS. What percent of the lessees in this situation are new companies?

The thrust of your argument, and if I were in your shoes I would take the same position, I would pick my best case and the best case is new companies, but what percent of the companies involved here are in fact new companies compared with others that are not new companies?

You know, the Occidentals of this world, and there are not many of them, are not new lessees, and they are able to be lessees in these situations because of their loss position due to foreign tax credits, et cetera. They are not new companies.

What percent of the lessees are in fact new companies based upon your present information?

Mr. CHAPOTON. Senator Baucus, we don't know yet what percentage are new companies.

Senator BAUCUS. Less than half?

Mr. CHAPOTON. I am sorry, I just couldn't say. When we get the tax return information in, we will be able to know that.

Senator BAUCUS. So the question is, how many lessees are neither new companies nor companies that are struggling and trying to do a good job, and so forth, therefore, in a loss position right now, as opposed to other companies that are neither new companies nor the company I just described, but due to deduction of foreign tax credits, et cetera, find themselves in a lessee position, therefore, able to take advantage of these provisions.

Mr. CHAPOTON. Senator, I am not trying to sell it solely on the benefit to new companies. It will benefit new companies. We are trying to sell it on the basis that it makes the investment cost equal to all firms; therefore, it gives the incentive to invest. Otherwise, we raise the cost of equipment to firms that don't have U.S. tax liability, for whatever reason.

New company, old company, established company, loss company—we want them all to have the same cost of equipment, and all the same incentive to make investments so that the marketplace will determine the most efficient investor.

Senator BAUCUS. I see my time is up.

My problem, frankly, with this provision is the same problem I have with the tax bill which we passed, which I reluctantly voted for. It is a broad brush, grossly inefficient solution to a difficult problem. We don't have the resources, we don't have the means to be so loose in our ways to attack problems.

I think we have a way to stimulate investment that is more targeted, that is more precise. Therefore, a kind of leasing provision, or refundability provision, or something in this area that is more precise and doesn't so loosely give such benefits seems to me to unintended companies.

Similarly with our Tax Code generally, I think as we move to individual rate reductions and ACRS changes, and so forth, instead of being so broad-stroke in giving such benefits to unintended areas, that we again should be more targeted, so that we hit the bull's eye instead of out in the farther rings of the target.

Thank you very much.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Thank you for a very excellent statement, Mr. Chapoton.

I listened and read your statement carefully and I believe your testimony was very accurate. I was just wondering if you would care to comment on why it is that the Washington Post and other such bastions of objective thinking have made such a big issue out of this particular program?

Mr. CHAPOTON. I think, Senator, and I don't say this in jest or facetiously, but I think a lot of this is due to misunderstanding. I think it is understandable when parties see major transactions involving tax benefits that one looks at them closely. I think that it is entirely appropriate that we do so.

Part of the misunderstanding is not realizing that $5 billion of leasing transactions, would have been carried on this year, and most of it at the end of the year, without ACRS and without safe harbor leasing. So a lot of it is not realizing what was going on before, and then a lot of it is not understanding the economics of these transactions and how amazingly efficient our marketplace will work, and the need for an efficient marketplace for a level use of the incentives, if you are going to give tax incentives for investment.

Senator SYMMS. To pursue that a little further. I have been discussing this issue with some of my colleagues, and some are calling for outright repeal of this provision. If the only thing they read is the Washington Post then I can understand how they have come to that conclusion. However, before that conclusion is reached, should we not examine corporate liquidity?

What is the situation with respect to private business liquidity right now; what impact, if this were repealed, would this have on business liquidity in this country, and how would that also impact the availability of credit for any other use of credit that might be necessary?

Mr. CHAPOTON. It is hard to speak in specific dollar amounts, but it clearly and obviously would adversely affect the liquidity of firms that would like to make investments, and would like to make investments that are profitable. With the tax incentives, firms can

make investments because it lowers the cost of investment. They can make investments that they would not otherwise make.

With leasing, firms can make investment that they would not otherwise make because it does increase their liquidity for that investment. They can make investments that they would not otherwise make because without safe harbor leasing they are denied the ACRS benefits. It is just as simple as that.

Senator SYMMS. I think you make a very good point. What we would be talking about is a drain out of the private sector where it is needed now.

I personally favored carryback when this started, rather than leasing. But I do think that you make an excellent case for the leasing provisions.

Mr. CHAPOTON. Senator, if I might interrupt, I think that this raises a good point. As you know, we objected at that time, and we had discussions about increased carryback, because that simply provided funds without tying those funds directly to new investment. The leasing example that I have used shows that where leasing is used, and where the tax benefits flow from leasing, significant capital investment has been made. It is true in every case and that is the result we want.

Senator SYMMS. Some of the critics of this are saying that small business is not using the leasing provisions; is that correct? I would think that small business would want to use them because of the progressive rates.

Mr. CHAPOTON. Absolutely. Small business, we think, most assuredly will be a big user of the leasing provisions. Without being able to state so based on any data, it would not surprise me if small business were late in getting aboard. The transactions do need standardizing before they could be widely utilized by small business because the transaction costs in the early years are greater.

But as they become more standardized, as parties become more accustomed to them, small business will be big users of the leasing provision.

Senator SYMMS. Is there any evidence that there will be more takeovers or mergers if the leasing provisions are repealed?

Mr. CHAPOTON. If they are repealed?

Senator SYMMS. If they are repealed.

Mr. CHAPOTON. There is no question that there would be more mergers and takeovers. Under prior law, there were tax motivated mergers. Indeed, we have provisions in the Internal Revenue Code to try to prevent that sort of thing. When you get large cost recovery deductions, it is going to happen, and if we did not have this safety valve on the system it would happen more.

There was an editorial, Senator, in a national magazine—I will not mention any names—in September of this year pointing out that because of the new ACRS benefits and the new cost recovery benefits, a wave of tax motivated mergers could be expected. The writer of that editorial did not know about, or at least did not mention, the leasing provisions, which would obviously prevent the mergers. Merger is not necessary since the user of the equipment can obtain the tax benefits without the merger.

[Document submitted by Senator Symms follows:]

PREPARED STATEMENT OF SENATOR SYMMS

This morning the Senate Finance Committee will be discussing the issue of leasing, an issue that has received considerable attention by the Washington Post and other such bastions of objective thinking.

While I personally favored "carrybacks" during the formulation of the Economic Recovery Tax Act of 1981 in lieu of leasing, I do believe that it is essential that the leasing provision be maintained for the present because of the illiquidity of the corporate and banking sectors. Leasing allows the private sector to raise capital within the private sector for reinvestment purposes.

Attached are several charts indicating the illiquidness of the private sector and a Congressional Record statement which, in part, discusses corporate and banking liquidity.

It is also important to review liquidity and its impact on inflation during the post-war period. After 1965, the U.S. entered a new and very disturbing financial environment. This can be traced in a number of ways. The post-war bull market in U.S. stocks, as measured by the Standard & Poor 400 industrials after adjusting for price inflation ended in February 1966. Related to this was the peaking out of current cost profits as a percent of replacement book value of corporate equity in 1966. Business cycle downturns after 1965 have become more severe, volatility in financial markets increased sharply and price inflation has persistently accelertated as the full consequences of past spending policies have come home to roost.

In the early years of the post-war period, all private sector balance sheets were stuffed with liquidity as a result of the depression and World War II. By 1965, this liquidity appeared to have been run down to the point where the Fed only seemed to be able to stop an inflationary boom by precipitating a liquidity crisis. The financial system had become sufficiently fragile that bankruptcies and financial panic developed before tight money turned economic demand down far enough to break inflationary psychology. As a corollary, each new recovery appeared to reliquify the economy enough to generate another round of prosperity.

Another major development related to the post-1965 change in the economic environment was the explosion in transfer payments. These grew in real terms at a rate of 4% from 1945–65. They then accelerated to a real rate of growth of 8%, and the projections for the future are in the range of 15 percent–20 percent. This sharply rising trend of transfer payments reflects, of course, the financial consequences of social democracy and the costs of a burgeoning welfare state and redistribution society.

After 1965, it has been clear that the private sector has been caught in the massive crosscurrents of inflationary pressure from the growth in government (particularly transfer payments) on the one hand, and deflationary pressure from the growing illiquidity of balance sheets on the other hand. The paradox of these crosscurrents, reflected in massive financial imbalances throughout the economy, was resolved through explosive increases in money and credit and, with a lag, accelerating price inflation.

Leasing simply provides more liquidity to the private sector so that the future recovery will not be because of an expansion of credit and money by the Fed.

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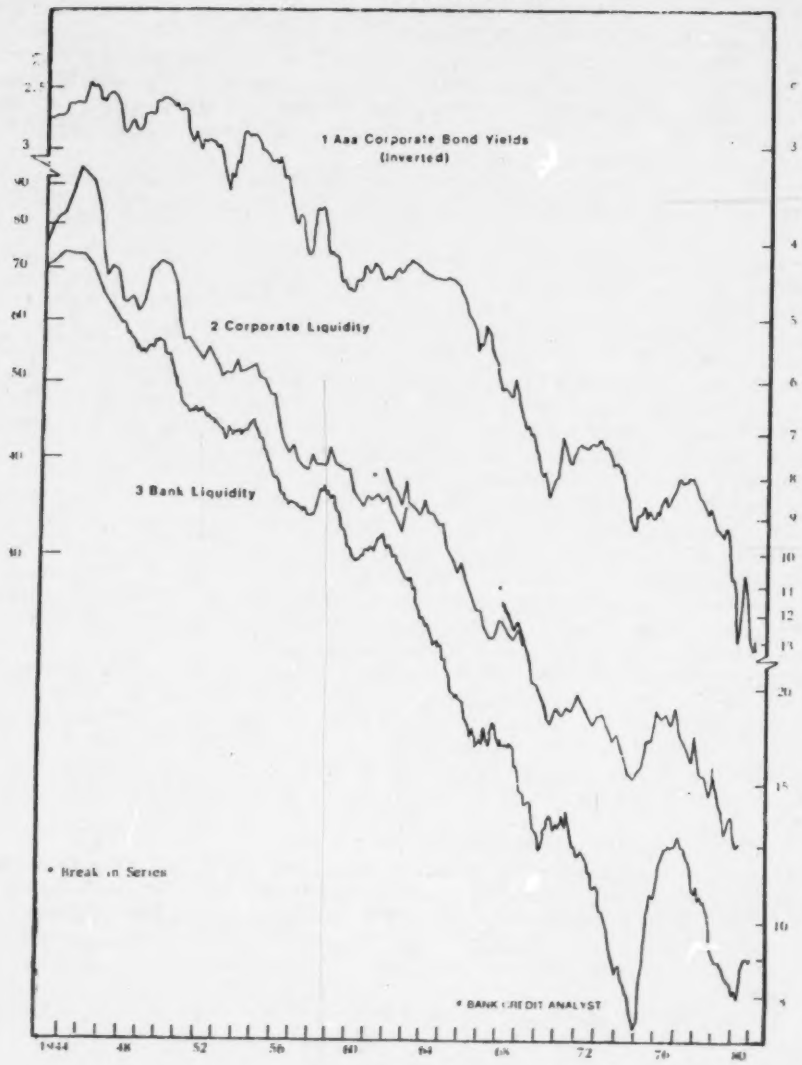
LIQUIDITY AND THE BOND MARKET



1 Average of daily figures of Moody's Corporate Aaa bonds.
2 Cash Assets as a percentage of Current Liabilities of U.S. corporations.
3 Government Securities as a percentage of total Commercial Bank Credit.

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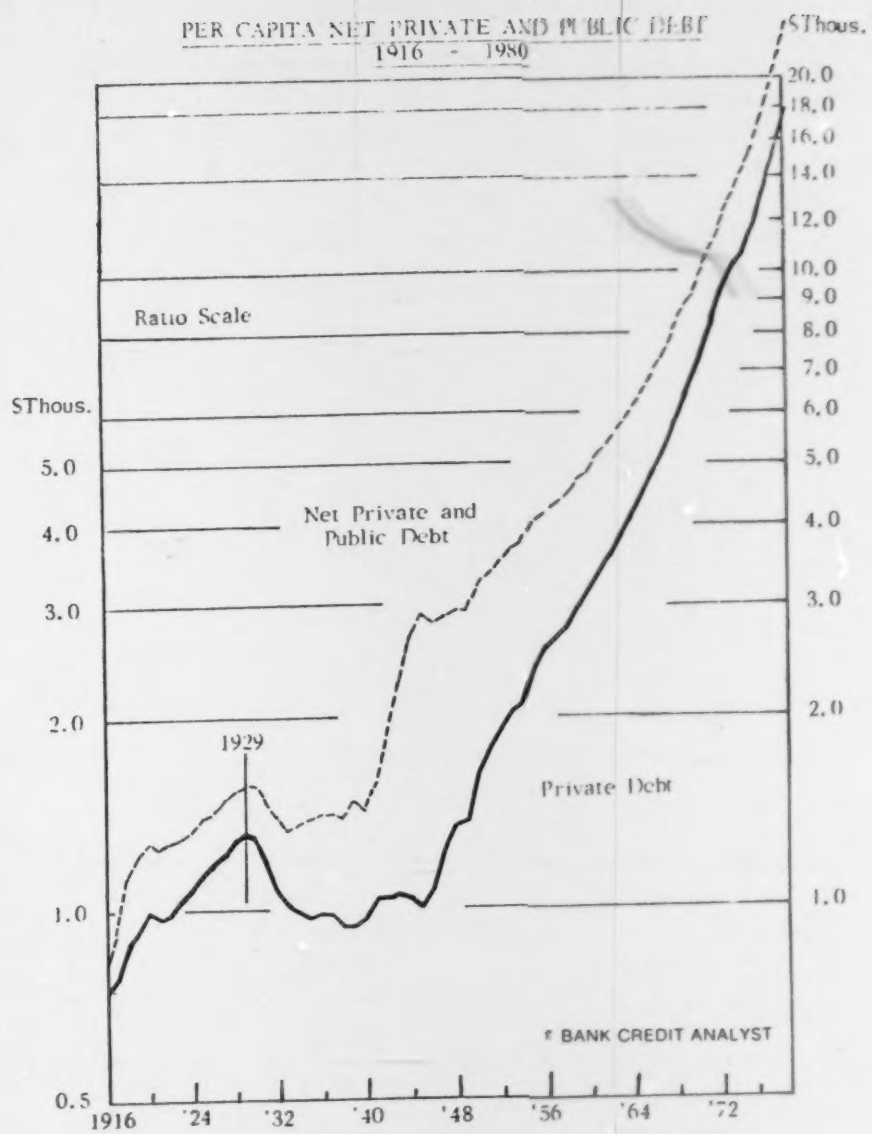

Source: U.S. Department of Commerce.
Federal Reserve Flow of Funds

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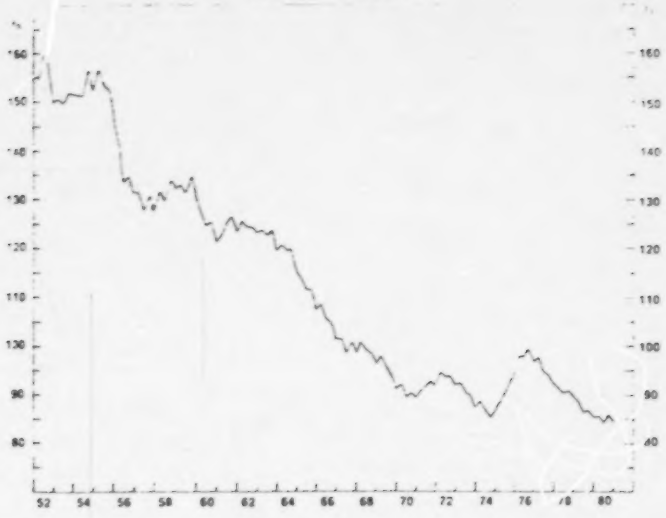
CORPORATE LIQUIDITY



1 THE CURRENT LIQUID ASSET RATIO IS THE RATIO OF LIQUID FINANCIAL ASSETS (FREE DEPOSITS IN FINANCIAL INSTITUTIONS AND MARKETABLE SECURITIES, U.S. TREASURY ISSUES) TO DEBT (CURRENT LIABILITIES: SHORT TERM CREDIT MARKET DEBT PLUS TRADE PAYABLES)

PERCENTAGE OF SHORT-TERM CREDIT TO TOTAL CREDIT MARKET DEBT
(NON-FINANCIAL CORPORATIONS)

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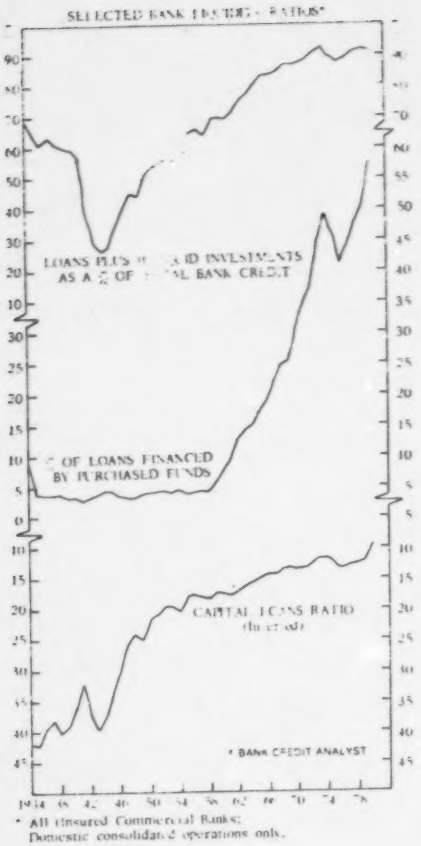
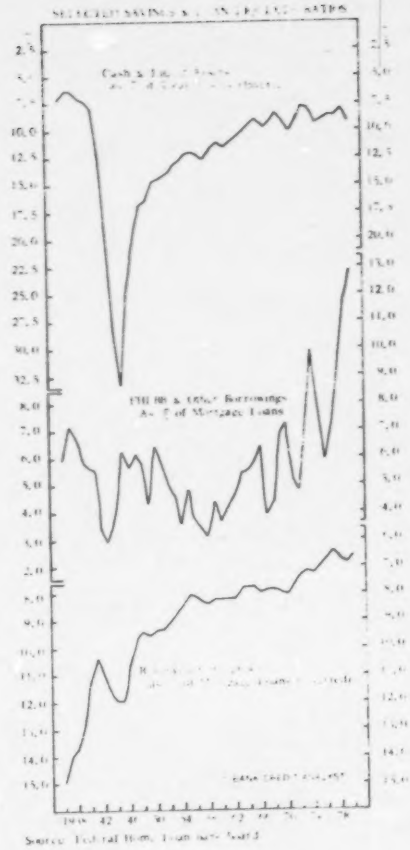


* All Insured Commercial Banks;
Domestic consolidated operations only.



Source: Federal Home Loan Bank Board

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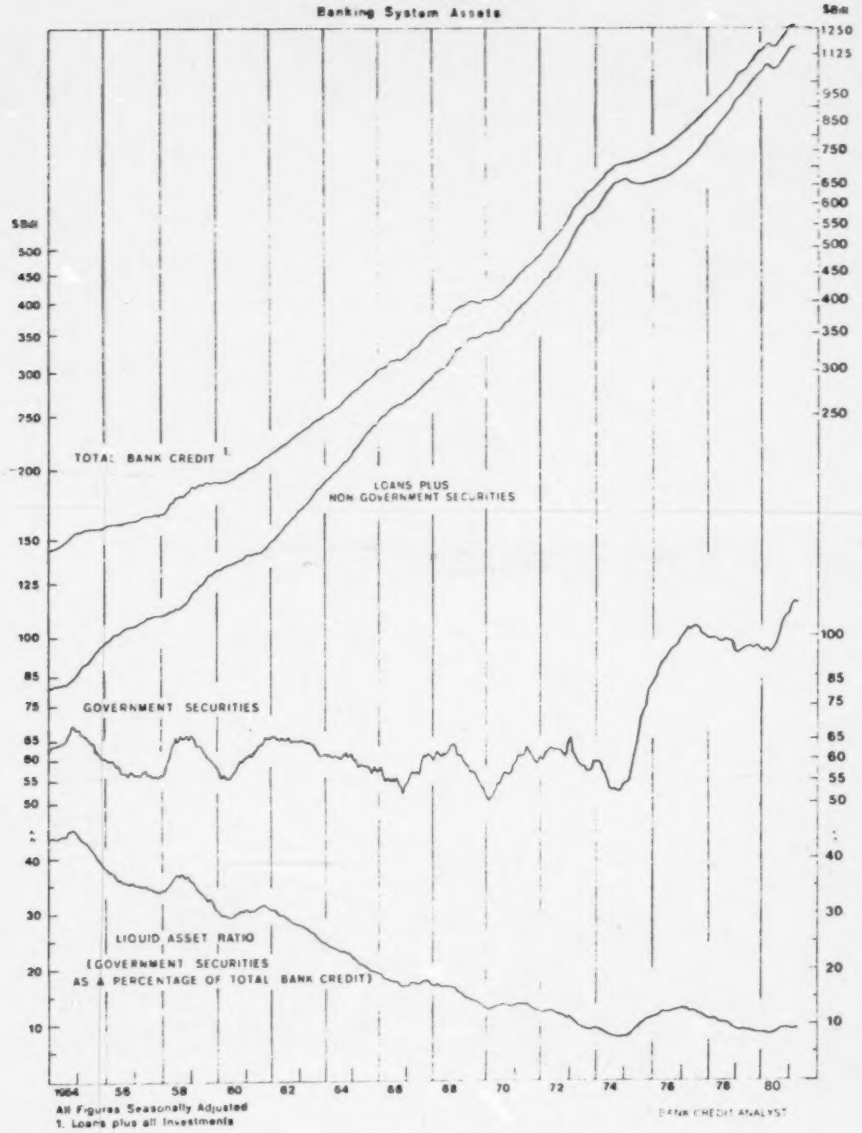
CHART I

COMMERCIAL BANK CREDIT

Banking System Assets



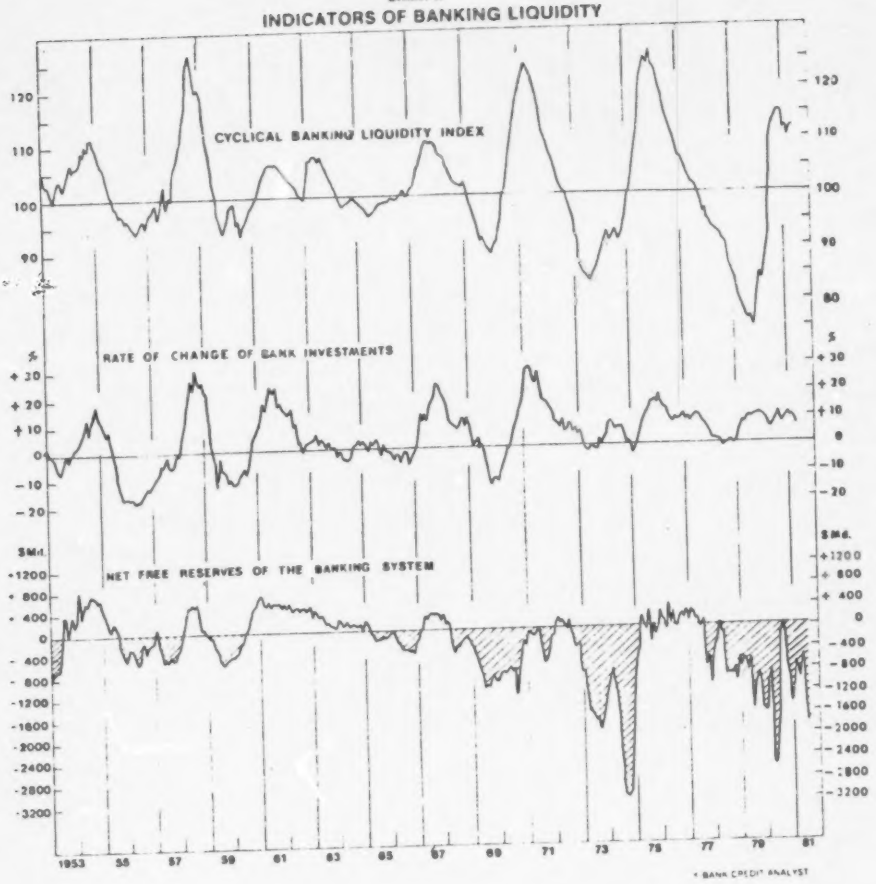
All Figures Seasonally Adjusted

1. Loans plus all Investments

BANK CREDIT ANALYST

CHART II

INDICATORS OF BANKING LIQUIDITY


CYCLICAL BANKING LIQUIDITY INDEX
RATE OF CHANGE OF BANK INVESTMENTS
NET FREE RESERVES OF THE BANKING SYSTEM
$Mil.
1953 55 57 59 61 63 65 67 69 71 73 75 77 79 81

* BANK CREDIT ANALYST

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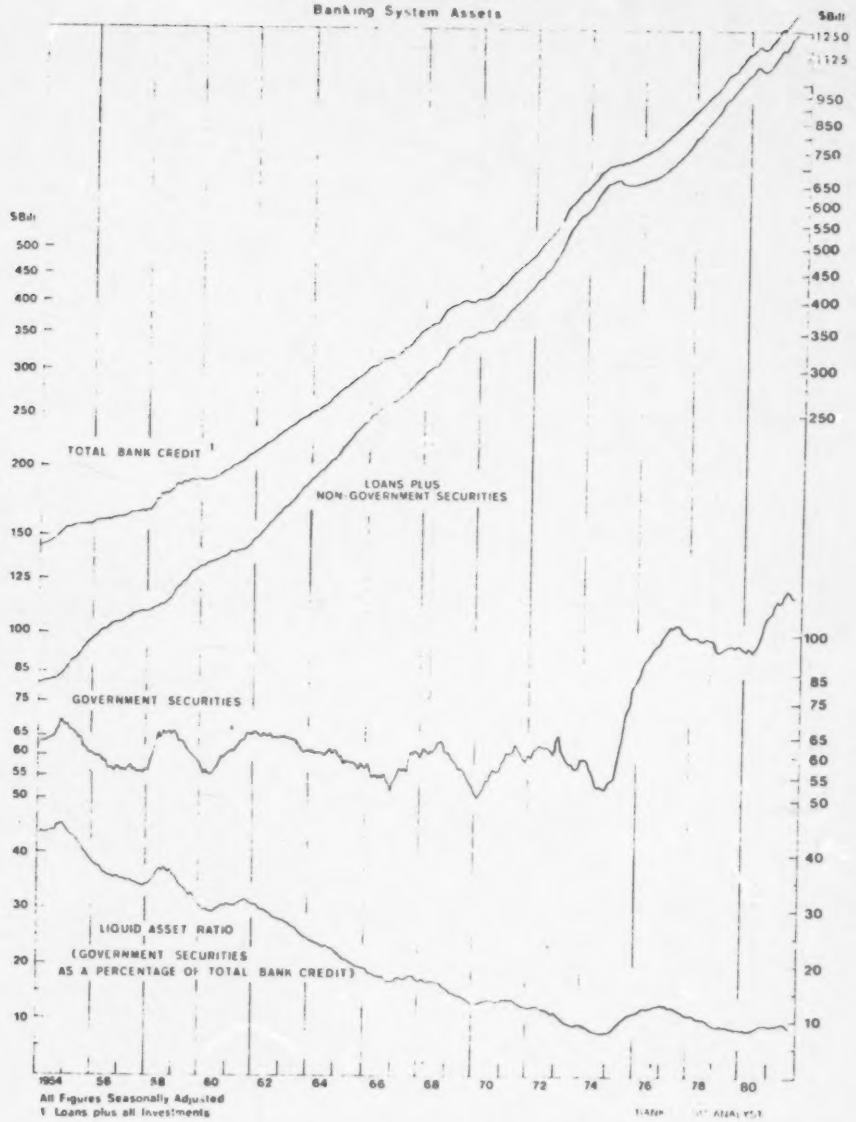
CHART I

COMMERCIAL BANK CREDIT

Banking System Assets

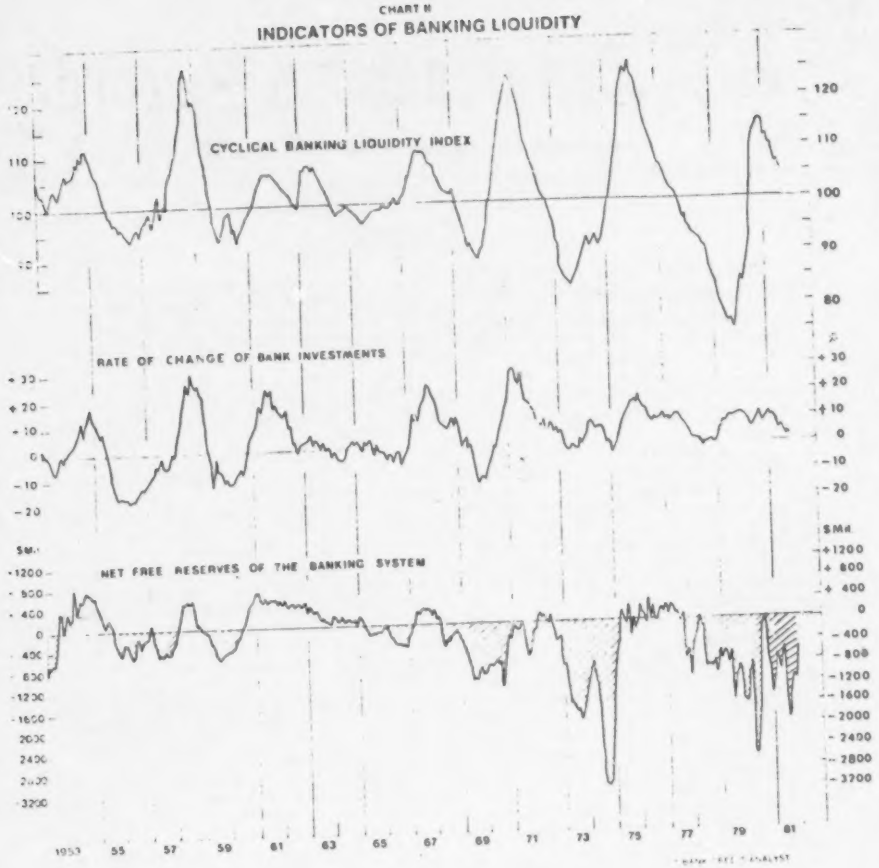


All Figures Seasonally Adjusted

1 Loans plus all Investments

CHART II

INDICATORS OF BANKING LIQUIDITY



United States of America

Congressional Record

PROCEEDINGS AND DEBATES OF THE 97th CONGRESS, FIRST SESSION

Vol. 127 WASHINGTON, FRIDAY, SEPTEMBER 25, 1981 No. 133

Senate

THE PRESIDENT'S PROGRAM

● Mr. SYMMS. Mr. President, last evening the President of the United States submitted to the Congress and the Nation this administration's proposed budget reductions which, in my opinion, are not heinous but extremely sensible in view of our current economic condition.

The President has recommended a course which absolutely must be taken if we are to avoid a liquidity crisis and debt inflation. There are a variety of forces in the economy and financial system which are combining to produce a very delicate situation that can only be addressed by significantly reducing the budget immediately.

The simple fact is that 40 years of accumulated debt is coming due. The administration inherited a situation in which expenditures have been growing faster than GNP and were projected to do so under existing law. It is not the fault of this administration that they are faced with the enormous problems resulting from a 40-year effort to spend ourselves into prosperity. However, it is the responsibility of this administration and the 97th Congress to attempt to resolve these problems.

President Reagan and a considerable majority of the 97th Congress ran for office on a platform of reducing Government expenditures and providing adequately for our defense combined with reducing inflation, and increasing productivity and prosperity. President Reagan is delivering the promise he made to the American electorate and I believe that the 97th Congress should not cancel their commitment to that same American electorate.

We only have three choices at this time: Reducing Government spending and therefore decreasing the Government's involvement in the credit markets, maintaining the current spending levels and therefore further squeezing the private sector's ability to obtain credit resulting in increased bankruptcies, or significantly increasing the money supply in order to monetize existing debt, resulting in an immediate increase in interest rates.

Obviously, the only resolution to our present economic dilemma is to reduce Federal expenditures in those areas of the budget which have grown uncontrolably in recent years. Simply reducing defense expenditures will not address this issue. There are those that will make the argument that a strong economy is more important than a strong defense and that a strong defense is not possible without a strong economy. However, historically the corollary has also been true—it is impossible to maintain a strong economy without a strong defense.

At this point I cannot help but recall the history of Carthage and Rome. Carthage was, in its day, the world's strongest economic power; but it failed to reckon with the growing military might of Rome. The same is true today of the United States and the Soviet Union. If the Congress refuses to support President Reagan's defense program, and thus allows the Soviet Union to maintain strategic superiority over the United States during the rest of the century, it will be impossible for us to have a strong and viable economy.

In recent years Congress has attempted to reduce the size of the Federal budget by cutting defense spending and increasing taxes. During the 1970–80 period, the budgets for income transfer programs increased 350 percent, while defense expenditures increased only 150 percent.

Unless Congress addresses the problem of the transfer payment and entitlement programs, we will never balance the budget. Even if defense spending were to be cut substantially this year, we would be faced with exactly the same situation next year. The entitlement spending would continue to grow, and still further cuts would be required in defense the following year. This would be a never-ending process until we reached the point where there was nothing left in the Department of Defense to cut—the end being a defenseless welfare state.

Furthermore, attempting to reduce the size of the budget by increasing taxes is not reasonable since it is not possible to increase productivity while strangling the economy with high tax rates. If the trend that was set in recent years continues, the market reaction will be "business as usual—Congress does not have the leadership or the fortitude to make

the necessary budget reductions." As a result, I am certain that the market's inflationary expectations will worsen.

In order to adequately understand the relationship between inflation, high interest rates, monetary policy and the need to reduce the deficit, it is essential to understand the volume and the nature of debt in the economy, as well as the revolution that has occurred in the financial system and the resultant supply and velocity of the money supply.

Initially, I would like to disabuse the popular belief that "someone" controls interest rates, for example, the Federal Reserve, the New York Stock Exchange, and so forth.

The market sets the level of interest rates. The level of interest rates derives from millions of individual and daily transactions between those who hold money and those who wish to use it. Borrowers will pay rates according to the urgency of their needs, the security they offer, or their prospects of gain from its use. Lenders will lend at a rate that reflects their loss of the use of the money plus a premium to cover the anticipated loss in purchasing power while the money is out on loan. All of this is apparent in the different yields and daily fluctuations in yield on various issues of bonds and notes in the market.

It is also necessary to disabuse the notion that the Federal Reserve controls the entire money supply. One of the major developments of the past 10 years has been the revolution in the financial system. An integral part of this revolution has been a progressive deregulation, reflected in near elimination of interest rate ceilings and the power of financial institutions to issue an enormous variety of new monetary instruments. These new instruments or substitutes are not controlled by the Federal Reserve nor are they reflected in the official monetary aggregates—particularly M-1B. These new instruments include:

First, a personal loan from a commercial bank which an individual deposits in a money market mutual fund;

Second, a corporate loan from a bank credited as an asset of a financial intermediary but treated as an "overnight repurchase agreement" which is "a deposit that does not count as a deposit"—a domestic Eurodollar, in effect;

Third, CD's with checks, whereby a bank will lend an individual any balance he needs to be able to purchase CD's in $10,000 blocks, allowing the customer to write checks—drafts on NOW accounts—on the entire balance of the CD, thus creating, in effect a money market fund within the bank;

Fourth, "retail purchase agreement," a collateralized loan to an S. & L., for which the customer receives interest rates competitive with money market funds on a very short-term basis—from 1 to 21 days—and check-writing privileges if he continues to roll over the loan.

There have been three major consequences of the revolution.

First, a bewildering proliferation of monetary liabilities has developed, making it impossible to clearly define a monetary aggregate which is suitable for central bank control.

Second, the interest rate subsidy to borrowers has been sharply reduced as individuals have been increasingly able to get market-related interest rates on their savings. This has caused a sharp secular shift upward in the whole spectrum of interest rates.

Third, monetary control is not assisted any longer by interest rate ceilings which in the past created disruptions to credit flows. Control works now almost completely through interest rates. The shift to reserve-based monetary control is really only a way of getting interest rates to change more quickly. It in no way makes such changes unnecessary. Tight money within a competitive financial system must mean high real interest rates. It is not possible to talk down interest rates while at the same time advocating tight money.

Yet, I would say our monetary policy is not necessarily tight because of the proliferation of monetary "substitutes" and the availability of credit. It only seems very tight because of the increased demand due to the size and nature of public and private debt.

Just because monetary policy has been accommodative enough to prevent the overall private sector from turning down further does not mean that policy has not been tight enough to do severe damage to the economy and financial system except in certain sectors. Because the financial deregulation movement has gained momentum, credit flows have remained much stronger at current interest rates than in any other period. The demand for credit has remained very high and the supply has been forthcoming. Liquidity and profitability have eroded dramatically because of the massive expansion of debt in recent years being financed a very high average level of interest rates. Interest rates will not decline unless there is a decrease in the demand for money and credit.

However, there is no indication that the Federal Government or the private sector will reduce their demand for money or credit unless the Federal budget is significantly reduced or there are a considerable number of bankruptcies. The private sector will continue to demand money and credit because they have to roll over existing loans. The borrowing has nothing to do with financing inventories or expanding plant and equipment. The borrowing is simply a means by which these companies are keeping alive.

The Federal Government is in the same position. The U.S. Government is now

spending $1 billion a day. The interest payments on U.S. Government debt will exceed the capital-generating capacity of the United States by 1983. The grim fact is now bidding for new billions of dollars almost weekly while refinancing old paper—often in the 5- to 10-percent rate area—at today's near record rates of 15 to 16 percent. The result of this adding and compounding action is to increase U.S. Government expenses beyond imagination. The average maturity of U.S. Treasury debt is down to approximately 3.9 years, and this debt is now rolling over and compounding at the highest rates in history The result is that the Treasury is literally cannibalizing itself.

The demand for money and credit is very apparent in examining the debt structure both domestically and in the offshore sectors. In both areas the problems are equally acute.

In the United States, the sum of all debt is referred to as the gross domestic debt. Ten years ago, such debt totaled roughly $1.8 trillion—today it stands at over $5.3 trillion. The largest increases were posted during the past 5 years. Although the gross domestic debt encompasses many other sectors as well, the dramatic rise in the debt of the Federal Government contributed heavily to this growth.

The Federal debt burden was almost reduced to zero in the midthirties. World War II, and the subsequent reconstruction effort, increased the debt to nearly $300 billion. Later, America's engagement in Vietnam caused a further surge in the debt spiral. By the midseventies the figure had reached the $500 billion mark. It took over 40 years to build up a debt of $500 billion; however, it took less than 5 years to virtually double tnat figure: On Monday September 28, the Senate will be voting on legislation to increase the debt ceiling to $1.079 trillion.

The steady growth in the debt has caused a vicious cycle. First, the deficit must be paid for with money that cannot be raised by taxation or other revenues. Therefore, the Government resorts to the issuance of more paper obligations: It monetizes the debt. This has a direct impact on the rate of inflation.

Inflation, in turn, increases borrowing demand in all sectors of the economy, unless interest rates are held at prohibitive levels. And, predictably, high interest rates put the pressure right back onto Government; which then faces drastically increased service costs for its existing debt. There are other problems as well. As the Government enters the credit market more frequently, the competition between itself and other borrowers increases. This forces up interest rates even further, only compounding the problem.

Another factor has been Government's response to the sharply escalating cost of servicing the debt. Quite often, it turned to private and corporate citizens for the answer, simply taxing them more heavily to meet the bill. This however, adds to inflationary pressures also, because it obliges companies and individuals to finance their capital needs by going further into debt in order to stay solvent or maintain a certain standard of living. At the same time, it slows the economy down as a whole, creating a climate of stagflation.

Is there anything which will prevent the rate of inflation from being pushed higher? The answer is quite simply: Nothing. Since the increases in the money supply are not tied to increases in U.S. production or a fixed commodity, there is no theoretical limit. There is however, a psychological barrier. And, I am hopeful that the 97th Congress has the fortitude to reduce the budget, as the President has suggested, because the debt has been the key contributor to inflation.

Another part of the U.S. domestic debt is the debt in the mortgage and loan sector. Although debt in this area is common to all economies, the American consumer's balance sheet has come under increasing pressure, in recent years. Largely to blame is the inflationary psychology, which characterized the late seventies and is still much in evidence.

In fact we are at a point where even a moderate downturn in interest rates will be perceived as a great bargain by a myriad of credit users who are now sitting on the sidelines. The most recent statistics show a marked decline in personal savings rates, which may only be the beginning of a great new trend. As mortgages have to be refinanced at current rates and banks ask for more interest on outstanding consumer loans, the private citizen's pocketbook will be directly affected. Since 1971, mortgage and consumer debts have risen 274 percent.

An area of particular concern is that of State and local governments, now contributing only 7 percent to the total of U.S. domestic debt. This figure could rise dramatically over the coming 2 or 3 years. State treasuries have had several good years during which, in the aggregate, modest surpluses were achieved. However, with the reduction in Federal expenditures, a greater burden will be imposed on State governments to finance programs that the Federal Government previously funded. Furthermore, measures such as proposition 13 add pressure to State budgets if the State continues to attempt to provide nonproductive services.

Perhaps of even more concern are local problems. New York City's close encounter with bankruptcy or Cleveland's financial near-collapse are two recent examples. The paper obligations of a number of American cities involve billions of dollars, and the risk of default

appears more likely now more than at any time since the 1930's.

In the corporate sector, the debt problem is concentrated on individual industries, rather than as an economy as a whole. Particular problems have surfaced in the automotive industry, although they are not the result of the current financial condition alone. One important point is that whenever sizeable industrial or commercial firms are on the threshold of bankruptcy, this translates into a direct addition to the debt burden of governments. There is no indication that the current Congress will discontinue this tradition of bailing out mismanaged private empires, but the Government seems to at least negotiate harder or even participate in the potential recovery of such corporations.

In recent months, the U.S. economy has shown remarkable resilience. I believe that many of the traditional industrial activities will become less important. New industries, many of them in the service sector, will gradually replace them. Such industries include oil and gas exploration, resource development, computer technology, et cetera. The fact that most of these new sectors of economic activity are in a strong expansion phase may be part of the current strength of U.S. performance.

All is not well, however, in the service sector of the economy. The best example of a highly endangered industry are the savings and loan companies.

The recent flurry of media coverage has accurately pointed out the seriousness of this problem. The emergence of money market funds caused large-scale withdrawals from savings and loan firms, cutting deeply into their profits. As an industry, S. & L.'s depend on short-term money, which is used to fund longer term loans. Together with high interest rates, which have an added negative impact on small financial intermediaries, this development proved fatal. The S. & L. sector is in sufficient trouble to have regulators scrambling for acceptable changes in the operating rules governing the industry. Such rule changes may postpone the problem, but will not effectively remove it. Whether financial government assistance will be necessary is too early to judge. One thing, however, is certain: the savings and loan sector is very important to the Government. It affects millions of small American savers and if bailouts are needed, the Government will be there.

Serious questions also overhang the opposite end of the banking scale: the very large, internationally active lenders. Most of their difficulties are in the area of offshore banking. Quite obviously the debt problem is vast and reaches into every corner of American life.

As intricate and hopeless as the labyrinth of domestic debt may be, it is easily surpassed in complexity by the Euromarket. At first glance the problem of offshore debt seems less alarming. After all, debt dollars outside the United States amount to $700 billion, a fraction of the massive $5.3 trillion domestic debt. A quick look at its growth pattern, however, destroys this notion; the Eurocredit market grew to its current size in just over 20 years.

Another important point is that a comparison of the sizes of the two markets is not realistic to begin with. The U.S. domestic debt includes a number of credit activities which exist in every economy—they are neither bad nor do they necessarily represent a problem. Public mortgage debt, for instance, is part and parcel not only of American life, but also of the Japanese, Dutch, or Swiss economies. Eurocredit, on the other hand, does not include any such traditional lending activities.

The Eurodollar market partly owes its existence to the cold war. In the late fifties the Eastern European governments decided to transfer their dollar accounts from New York to Europe. This step was no doubt motivated by the fear that their funds could be blocked in the United States if the political situation deteriorated further.

At the same time, many Third World transactions started to be denominated in American currency, replacing the Pound Sterling as the leading currency. The combination of these factors led to a dramatic expansion of this new market. But other advantages soon became evident. First, no one had any jurisdiction over U.S. dollars outside of the United States. Second, the growing activity in the Eurodollar sector created exciting interest rate differentials vis-a-vis the domestic dollar market. Moreover, there was a very good chance that the new Eurodollar would remain freely convertible: the U.S. balance of payments deficits of the early 1950's had contributed sufficient liquidity to the international markets.

Before long, the Eurodollar flow made the development of whole new offshore banking centers possible. Initially London dominated the scene, but Nassau, Singapore, Luxembourg, and the Cayman Islands followed—the prefix "Euro" became a misleading one. The freedom with which international bankers were able to operate, made the new market into the prime arena for their creativity.

But there are many challenges to that creativity. In the late sixties, and throughout the seventies, the Euromarket became the principal haven for OPEC surpluses. Scores of less developed countries (LDC's) hard hit by a sequence of drastic oil price increases tapped the market as anxious borrowers. As the wealth-disparity between those having oil and those using it increased, the Euromarket became not only a source for survival for nations resorting to deficit financing, but of unexpected riches for many international

banks.

Its nature and function allowed many to profit. After an initial placement is made with one of the Eurobanks, funds enter the "interbank market" where, in part or lumped together, they may be deposited several times at fractionally higher rates, before the final bank in this sequence finally lends to a user. The risk is therefore spread around which gives the market a certain strength. This very strength, on the other hand, is in one way also the Euromarket's greatest weakness.

As a result of the interbank process, there is no clear indication to the initial lender where his funds will ultimately be put to work. Add to this the fact that Eurobanking operates outside of conventional banking jurisdictions and the danger becomes apparent. Without reserve controls and defined rules of credit risk assessment, the Euromarket is limited in its potential only by each bank's willingness to extend loans. And, as has become obvious in the past 4 or years, the desire to realize profits and be an aggressive lender often surpassed normal standards of caution.

The willingness of international banks to reschedule delinquent debts provides sufficient evidence. The most recent case in point is the Polish debt problem. Behind all of the cautious doubletalk conveyed through the news media lay one frightening fact: As the world awaited a Soviet invasion of its satellite, Poland was- delinquent in paying interest on nearly $25 billion and had failed to make repayment of a large sum which was due.

In the meantime, the German banks who had been the most aggressive lenders to Poland, have been forced to defer such payments for a period of 3 to 5 years. But that was not the end—the banks also had to provide additional funds to keep the defaulting country going in the meantime. The sad alternative, of course, would have been a total default on Poland's part and, on its heels, an international banking crisis.

In view of today's political developments, Western credits to the Community economies (Comecon) provide an interesting study. Dollar-dominated debt to such nations now tops $50 billion. To begin with, the economic problems of Eastern Europe are becoming increasingly intolerable, which already reduces the chances of prompt and trouble-free repayment of this debt. Perhaps even more important, the rapid return to a cold war atmosphere, may also contribute to the potential of additional Comecon defaults.

Most of the credits to the Communist nations, incidentally, are related to East-West trade And, as the students of history well know, trade has been used as a political weapon before. Of course, the assumption that these vast sums due to Western interests will be used as the pawn to some political maneuver is speculative.

But Comecon is not the only source from which trouble may emanate. Far greater in its proportions is the debt due from less developed countries (LDC's). The credits extended by the private sector to the leading 11 borrowing nations alone exceeded $80 billion. Add to that literally dozens of smaller countries and take into account funds lent by governments of industrialized nations in the form of export credits, official aid, and so forth, and the total debt burden is nearly $400 billion.

It is fairly easy to trace the expansion of this sector of the international credit market. As already mentioned, the origin of all problems involving LDC's lies in the rapid adjustment of oil prices in the late sixties and throughout the seventies. At the time OPEC started its plan to catch up with the devaluation of the U.S. dollar, the LDC's were achieving a relatively good rate of growth. This was primarily due to significant economic support they received from the industrialized West. The shock wave caused by the quadrupling of oil prices, however, staggered the Western economies, plunging the Third World into a deep crisis.

The continued development of LDC's was imperative because a drastic change in the level of aid to the 800 million people affected could have caused the economic crisis to escalate into a social and political one, a trend that would have been unacceptable at the time.

During that time, LDC's scrambled for money everywhere. Unable to stretch their export capacity and production further, they turned to international relief and development agencies for help. To a small extent they were accommodated, but the major part of their borrowing had to be financed through the private sector. There, unforeseen liquidity had been added by the massive surpluses realized by OPEC nations. Although private money was more expensive and there was by no means a lack of bidders, LDC's managed to secure loans at relatively favorable rates throughout the early seventies. Recently this pattern has changed.

As oil prices continued to spiral upward, funds from international agencies disappeared. The governments of Western industrialized nations now faced opposition to their contributions to organizations like the World Bank or the International Monetary Fund. Unable to attract further funds from industrialized countries because of a change in political atmosphere, these agencies turned to OPEC for assistance. Predictably, the oil-rich nations were reluctant to contribute to these organizations, which were decidedly under the political and economic influence of the West. Instead, an independent development fund was proposed and this project is still in the process of being established.

For the past few years then, the private sector has been saddled with a much larger share of debt financing. Such credit activity peaked in 1979 when funds due to international banks amounted to nearly $40 billion. In 1980, this figure dropped but significant further reductions will remain to be seen.

By far the largest problem is that of debt-rescheduling. Increasingly many nations are unable to pay back maturing loans. So often have deperate lenders gone through the motions of throwing good money after bad that it has become somewhat of a ritual. Although few are impressed by the accompanying rhetoric and the subtle terminology chosen for these refinancing operations, the media have kept remarkably quiet about them.

In 1980 there were at least six nations who were unable to repay their maturing debt. Not only did they have their credit renewed, but they also received additional funds to be able to pay interest. The international banking community appears painfully aware of the problem. And predictably, this makes life even more difficult for the credit hungry LDC nations.

As in all sectors of our financial system, interest rates rise when the risk increases. Brazil, now the heaviest borrower in the Euromarket, now has to pay between 2 and 3 percent above the London Interbank offered rate, an important indicator. A number of other countries have been asked to pledge collateral for all future loans. On average, over 40 percent the LCD's export proceeds are used to service the debt. In a vicious circle, one of the very consequences of the principle of deficit financing is hitting right back at the market—escalating interest rates and the resulting state of disrepair in the bond market.

Just how pressing the Third World plight is can be illustrated in a very basic comparison. At present price levels, the cost of Third World oil imports is twice as high as the aid received from all sources. This situation is obviously untenable and will, before long, lead to a crisis of enormous proportions. Not only do these nations need additional money to meet their current needs, but it has also been estimated that they require three times their present import levels of crude oil to return to their growth and productivity levels they had in 1973.

Some time ago, Fidel Castro addressed the United Nations and suggested that the Third World unite and declare to the West that their loans granted for "exploitative and selfish reasons" would not be repaid. What was frightening was not that a Communist leader would make that statement but that he received a standing ovation.

It seems certain that if difficulties arise, the difficulties will not be confined to just one area of the credit spectrum. The financial statements of large American banks and their subsidiaries clearly show that a significant portion of profits are generated by offshore lending activities.

It follows that the default of one or more Comecon or LDC nations could affect the financial health of individual banks. Once the overseas operation of a banking institution has a problem, it inevitably translates into the domestic sector. Thus, these individual financial institutions are far more interdependent than appears at first glance.

Based on Federal Government statistics, 56 percent of the present debt is mortgages and loans; 20 percent of the debt is Federal; 10 percent of the debt is corporate bonds; 7 percent of the debt is State and municipal bonds; 4 percent of the debt is foreign debt; and 3 percent of the debt is money market debt. The life of all debt is becoming more short-lived and is being refinanced at ever increasing interest rates.

The rundown in liquidity has occurred in all sectors of the economy—businesses, households, depository financial institutions and State and local governments. The effect of the U.S. monetary squeeze has been internationalized because of the strong dollar and the U.S. balance of payments surplus. Thus, the entire world is caught in an enormous liquidity squeeze. All inflations necessarily lead to reduced liquidity. The longer the inflation goes on, the greater the rundown in liquidity. The danger is that when monetary policy moves to contain inflation, liquidity is necessarily eroded even faster for a time.

This phenomenon worsens as inflation increases. The dynamic force of inflationary destruction of purchasing power assumes a life of its own, which is beyond the control of any central bank or governmental authority. The velocity of currency in circulation increases in almost geometric proportions, as the dynamism of currency debasement intensifies. It signals that as a monetary unit progressively loses purchasing power, it has to work harder and harder to match the ever-rising price level.

Thus, the speed at which checks and banknotes change hands to maintain economic activity becomes faster and faster. Under such conditions, a larger proportion of any demand stimulus will go toward increasing prices than toward real growth.

At present there are two monetary forces engaged in a fearful tug-of-war. On the one side, the historically high interest rates strive to generate economic contraction. And on the other side, the rising deficits in the Federal budget are keeping the dynamism of inflationary momentum intact.

According to Treasury's statistics, $252 billion of old debt will have to be refinanced in the near future and $90 billion of new debt will soon be offered. At present interest rates, the increased cost of financing the Federal debt alone is stag-

gering.

Monetary policy is, in effect, the only tool of restraint at present since the uncontrollables in the budget have not been controlled. A tight monetary policy, if maintained, and if other policies are adopted which are consistent with this objective, is capable of bringing inflation under control without first destroying the economy—but not without some pain. Theoretically, monetary policy is capable of controlling and sharply reducing inflation. However, it is simply not feasible to instruct the central bank not to increase the supply of reserves if the result is the destruction of the private sector of the economy. What causes the destruction is the role of the public sector in imposing excessive claims on the economy.

The existence of an excessively large public sector greatly complicates the operation of monetary policy when it is operated in a freely competitive economy and financial system. The problem stems from the fact that the public sector is essentially immune from the effects of monetary policy. When rising interest rates are used as the essential control tool, they are never aimed at reducing public sector demands. In fact, they actually increase those demands.

The immunity of the public sector from monetary policy means that the impact of monetary policy is concentrated in the private sector—particularly the manufacturing sector. To make matters worse, over time the private sector has been declining in proportion to the rest of the economy, while the proportion taken by the public sector has been growing. With this shift in relative size, the only way inflation will be squeezed out of the economy and interest rates reduced is by an avalanche in private sector bankruptcies and an unemployment rate of over 20 percent.

If the immunity of the public sector to monetary policy were not enough, certain items of public sector expenditure are deliberately designed to offset the effect of monetary policy. The so-called automatic stabilizers, for example unemployment benefits, plus deliberate attempts to maintain demand, coming on top of the general indexing of the majority of expenditure to inflation, act in direct opposition to the contractionary effect of a tight money policy. There is a major conflict between monetary policy and fiscal policy, between attempts to reduce inflation and attempts to maintain demand which sustains inflationary pressure. As a result, monetary policy has to be very much tighter than would otherwise have been the case, and it will have to be maintained longer. The conflict that is set up also implies much greater volatility in financial markets and the economy in general.

These conflicts in the application of policy create increasing distortions within the economy. In particular, they imply added penalties for the private industrial sector, which in any free market economy provides the major engine for growth and productivity increases. The reliance on monetary policy to control inflation without at the same time recognizing the conflicts created by an inconsistent fiscal policy is unnecessarily reducing the growth potential of the economy by squeezing the size of the private industrial sector relative to the public sector.

There is another aspect to this conflict which arises within the central bank itself. It must quickly become clear how monetary policy crushes certain sectors of the private economy and this will tend to make the central bank back away from actually destroying what might otherwise have been viable enterprises. The only other option the central bank would have would to either wipe out whole industries or drive them into the arms of the public sector.

Discipline has worked its way back into the system but now it rests entirely on monetary policy. Tight money will provide temporary relief from inflation, however, when faced with an opposing fiscal policy there is an increasing cost. A long-term solution depends crucially on the public sector reducing its own financial demands. It is important for the 97th Congress to recognize the limitations of Government action, and ease to some extent the props that have been put under demand. I urge all of my colleagues to join with the President and continue down the course that has been set to economic recovery.●

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Senator BAUCUS. Would the Senator yield on that point?

Senator SYMMS. I will be happy to yield.

Senator BAUCUS. Is the administration therefore opposed to mergers, and the concentration of economic power? It was in your statement that you are upset with the concentration of economic power.

Mr. CHAPOTON. I think a tax motivated merger serves no economic purpose.

Senator BAUCUS. But your argument in favor of leasing provisions is that repeal would encourage mergers. The premise behind that is that you are opposed to mergers, you are opposed to the concentration of economic power.

Mr. CHAPOTON. No, that is not correct.

Senator BAUCUS. That is what your statement says, and I will read it back to you. Page 6, "Such tax motivated mergers would serve no economic purpose, but would lead to a greater concentration of economic power." A lot of mergers are tax motivated, and I would submit that most are, but I don't hear the administration on that basis, because they are tax motivated, oppose them.

Are you saying that you are opposed now to tax motivated mergers?

Mr. CHAPOTON. I am saying that a tax motivated merger is not an economically efficient transaction.

Senator BAUCUS. You have been using that as an argument as to why we should not repeal or substantially change these leasing provisions.

Mr. CHAPOTON. Absolutely. I might mention that the current wave of mergers that you are seeing are not tax motivated.

Senator BAUCUS. I suggest that you talk to the Justice Department, or that the two Departments get together on that.

Mr. CHAPOTON. I think the Justice Department would agree that tax motivation should be rendered as little an element as possible in mergers.

The CHAIRMAN. Senator Long.

Senator LONG. It seems to me, Mr. Chapoton, that all you have got to prove to win your case is to prove that the new rule is better than the old rule. That is all you really have got to prove.

I recall when I first started as a debater, I wanted to prove my whole philosophy of life and government, and everything else. My debate partner had more experience than I had, and he said, "You don't have to prove all that. All you have to prove is that it is better the way you advocate it than it was before."

We have had these leasing provisions around for a long time, and I have not heard one whisper of criticism up until now. Can you tell me how long people have been using leasing provisions so that they could take advantage of the investment tax credit, for example?

Mr. CHAPOTON. Since the investment tax credit was instituted in 1962.

Senator LONG. I have been around here all that time. I had some doubt about the investment tax credit when they passed it, because it was clearly a subsidy. Some of us thought that it was almost a giveaway because it was giving a person an advantage for an ex-

pense that did not really exist. You let him depreciate the whole thing, and he would get the investment tax credit, too.

I had some doubts about that, and even required in the beginning that you could only depreciate 90 percent because you only paid for 90 percent. After a while it looked like it was doing a lot of good, so I decided I would relent on that, and let them go ahead and get the 10 percent, and depreciate all the rest of it.

It was clearly a tax subsidy, and it was intended that it be a subsidy that would be used by the Tax Code, and it was thought that it was a better way to do it because people knew that they were going to get it, they did not have to rely upon some Government bureaucracy to get it, and they did not have to worry about the uncertainty of Congress changing its mind every time they woke up on a new day and find that somebody had an amendment to an appropriations bill or something out there.

It was a better way of doing business, and nobody quarreled about it. In other words, if Pan American Airways wanted to buy an airplane, and they couldn't use the investment tax credit, then if they were borrowing money from the Prudential Insurance Co., then Prudential could buy the airplane and take the investment tax credit, and lease the airplane to them, and they could lease it a lot cheaper because they benefited from the investment tax credit.

That type of thing has been going on up until now, hasn't it?

Mr. CHAPOTON. That is correct.

Senator LONG. Nobody has found any fault with it.

Here are the rules that you had to contend with, until you came out with your new rule. The question is, is the new arrangement better than the old arrangement?

Let's look at point No. 1. The lessor had to have a 20-percent minimum at risk investment in the property throughout the lease term. If I were a company that was trying to help Pan American—Let's say I was the Prudential Insurance Co. trying to help Pan American buy an airplane, and suppose I had been helping them by lending them money, they were a customer of mine. Could I make Pan American a better deal so they could get more of the investment tax credit or more of their depreciation allowances if I did not have to have the 20 percent at risk, than if I had to have the 20 percent at risk?

Mr. CHAPOTON. Absolutely.

Senator LONG. So you cut the 20 percent down to 10 percent.

Mr. CHAPOTON. That is correct.

Senator LONG. That means that if Prudential is making the deal with Pan American, Pan American can get more of the benefit.

Mr. CHAPOTON. That is correct, Senator.

Senator LONG. So that is clearly an improvement on the old rule. It is to carry out the purpose of the people who are buying the equipment, would get the benefit of it; is that correct?

Mr. CHAPOTON. That is right.

Senator LONG. I would charge anybody to prove to me that it is not a better rule than the old rule.

Now let's take the second point. The lessor must have a positive cash flow and a profit from the lease, independent of the tax benefits. Here you are again, Pan American, competing with all the rest of these guys. They are getting what amounts to about a 30-percent

subsidy because of the tax benefits. So when they buy an airplane, if they buy an airplane that costs $10 million, they get it for $7 million. You have to pay $10 million, and it is all you can do to keep your nose above the water the way it is now. That is not fair, is it?

Mr. CHAPOTON. That is not fair, and that rule is totally unrealistic. People don't analyze transactions absent tax benefits.

Senator LONG. If you are talking about whether the deal is justified, why on God's green Earth shouldn't you consider the 30-percent difference in what you have got to pay? What sense does it make not to take that into consideration while the deal is a justifiable deal?

Mr. CHAPOTON. That is correct.

Senator LONG. Do you see any good reason for not considering the tax benefit?

Mr. CHAPOTON. We thought that it made no sense at all. That rule has given us some problem for some time.

Senator LONG. It makes no sense at all. Once again, putting that rule in makes it that much more difficult for Pan American to get the same consideration that all their competitors are getting in buying the airplane; isn't that correct?

Mr. CHAPOTON. That is correct.

Senator LONG. So to change that rule is to benefit the people that you hope to benefit, and to let them get more of the benefit you are hoping for them to get. That is all there is to it.

Mr. CHAPOTON. That is right.

Senator LONG. Here is the third rule. The lessee must not have the right to purchase the property at less than fair market value. Again, in that situation you are trying to get the benefit to the company that is doing the best it can to try to get out of the red and into the black. Why should you not let them make a deal where they could get the property at a low price at the end of the lease term?

Does that particular provision help or hurt Pan American when they try to buy the airplane?

Mr. CHAPOTON. It hurt, and it ended up with the airlines buying back the airplanes from banks after the term of leases, and that was a common event.

Senator LONG. So again if you want the benefit to go where you intended it to go, to change that third rule is good for the people you are trying to help, that is the company that is getting the worst of it.

Mr. CHAPOTON. That is correct.

Senator LONG. This next provision, the lessee must not lend of the purchase cost to the owner—I think that is a relatively minor one—and it should be immaterial.

Let's look at No. 5. The use of the property at the end of the term of the lease by a person other than the lessor must be commercially feasible. What is the point in that?

Again, let's apply this to the lease with Pan American. They are trying to find a way for Pan American to get the benefit of that tax credit, or the depreciation advantages. Why have you got to require that somebody, who has a tax liability and who could do business

with them, that Prudential be in a position to go into the airline business; what is the point in that?

Mr. CHAPOTON. It substantially reduced the leasing market, and therefore raised the cost that much higher.

Senator LONG. The more people who have a tax liability who can trade with Pan American, the better deal Pan American can make when they are trying to sell a tax benefit; is that correct?

Mr. CHAPOTON. Absolutely.

Senator LONG. And Pan American is the one you are trying to help.

Again, let's look at another situation. Here we could have a tax subsidy. It has been a congressional decision that the risk was justified of putting in some money to try and save the Chrysler Corp. If we are going to do that, why should we pass a law that would discriminate against Chrysler in favor of General Motors, Datsun, Toyota, or God knows who else, by denying Chrysler the tax benefits that all the rest of them would get?

Mr. CHAPOTON. That is correct. Without leasing, it would be exactly the result. The equipment would cost more to Chrysler than it would to GM.

Senator LONG. They may be able to make a case, but I just challenge them to show where the old rule is better than the new rule. If the new rule is better than the old rule, I don't know why anybody should argue about it. I will just wait with interest to see if people can prove to me that this old rule is better than the new rule, because if they can't do it, I don't think they have got a case.

The CHAIRMAN. I might say in that regard, we have searched the record, and we can't find anybody who is criticizing the new rule who is criticizing the old rule. I don't know what happened.

Senator LONG. If I might just make my point and conclude this.

The CHAIRMAN. Including the papers.

Senator LONG. Here is something that nobody criticized. This takes me back to my days in the Navy. We would be doing business a certain way over a period of time, and we thought we were doing fine and getting the job done. Suddenly there is some new captain or admiral who comes aboard, and suddenly you think the whole bunch of us are going to go to the penitentiary for 10 years for doing something that nobody had complained and nobody had criticized for years.

Here we have a rule that nobody found any fault with until you came up with a better one. Then suddenly you think the world is going to come to an end. That to me does not make any sense.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Secretary, it has been established that this provision was not a part of the President's original tax package. The original tax package was submitted to the Congress in February. This proposal came to light insofar as the Congress is concerned on June 9.

Mr. CHAPOTON. That is correct.

Senator BYRD. There was very little discussion of this proposal when it was before the Finance Committee. I don't say that this does not have merit. I don't buy all of Senator Long's thoughts with regard to it, but I can see that it does have some merit.

What passes through my mind, however, is how much additional tax benefit should we give to business. The President's original tax program gave to business a very substantial tax advantage, just as it did to individuals. When it got to the Congress, it was greatly expanded, and this is one area of expansion.

So while I am not arguing totally against the merits of the proposal, I am concerned about the numbers. This gives an additional tax advantage to somewhere around $27 to $30 billion, and there is a question in my mind as just to how far we can go in giving tax advantages under the existing conditions of these huge projected deficits.

Mr. CHAPOTON. The package from the President did not include the leasing provisions. The next proposal was the June 9 Conable-Hance bill introduced in the House, and which was basically considered by this committee on June 10. On June 10, in that proposal, we also made some other changes in the ACRS system which cut back on the ACRS system, reducing the revenue costs considerably.

Senator BYRD. What proposal are you speaking of?

Mr. CHAPOTON. I am talking about the changes in the proposal from February 18 to June 9.

Senator BYRD. You say that you made changes, or reductions.

Mr. CHAPOTON. We made four changes, and I am reading from a factsheet, and I will be happy to enter this into the record. The June 10 factsheet on the changes in the program were these changes: First, all structures were placed at 15 years under 200 percent declining balance. Before that time, some had been at 10 years and some had been at 15 years. That reduced the revenue costs by the following, and I will just read off the figures quickly: In 1981, $.2 billion; in 1982, $.8 billion; in 1983, $1.4 billion; and in 1984, $1.7 billion, and on out.

The second change was that we limited the depreciation deductions for equipment from the original 200 percent declining balance to 150 percent declining balance through 1984.

Senator BYRD. So you disadvantaged virtually all business by doing that in order to bring in this proposal?

Mr. CHAPOTON. That is correct. It was a cutback in the ACRS benefits with the addition of the leasing provisions to spread the benefits to more business overall.

Senator BYRD. What you cut back there affects virtually all businesses.

Mr. CHAPOTON. That did affect virtually all business because there was a reduction in the ACRS benefit.

Senator BYRD. Correct. So you affected adversely virtually all businesses in order to do something about this proposal?

Mr. CHAPOTON. In our view, we wanted to cut back on the ACRS benefit across the board to make the ACRS benefit available across the board.

Let me correct something because I see that I made a mistake. The real estate provision cost was slightly more expensive, so the figures I gave you were additional costs. There were four changes at that time, and those were additional cost figures. The reduction in benefits that I just described would obviously save significant revenue.

The third change was the elimination of the deduction for qualified progress expenditures. Under the February 18 proposal, we would have allowed depreciation to begin when a payment is made for equipment with a long construction period, rather than when it is placed in service. We removed that rule, and that reduced the benefit.

Senator BYRD. There again you are disadvantaging more businesses to get to this proposal.

Go ahead.

Mr. CHAPOTON. The fourth change was adding the liberalized leasing rules, and the revenue estimates are shown on this fact sheet.

Senator BYRD. None of those figures add up anything like what this proposal costs, and then you are talking the losses in the outyears, that is when the big losses will occur.

Mr. CHAPOTON. Senator, the net change from all these changes was to reduce significantly the cost of the ACRS proposal. In other words, the other changes more than paid for leasing.

Senator BYRD. That is why I am telling you. You reduced your original proposal in a way that adversely affected virtually all businesses in order to go to this proposal. I am just wondering whether we were wise in doing that.

Mr. CHAPOTON. Senator, let me point out something that was facing us at that time. Under previous law, almost half of U.S. corporations, or 46 percent in terms of number, had no current U.S. tax liability in any year. Most of those are small companies, and they have no current tax liability for a variety of reasons.

Under the old rules, most companies have no tax liability. Therefore, if you are giving them ACRS benefits or faster cost recovery, you are not doing anything for them.

Senator BYRD. We are not doing anything under this for those same small companies that are losing money. They are not going to take advantage of that.

Mr. CHAPOTON. No, Senator, we are, that is the purpose. They can use the leasing provision and obtain ACRS deductions through a leasing transaction. They would be denied that right under the old law, or would be given that right only under higher transaction costs.

Senator BYRD. It still seems strange to me that you would 3 or 4 months down the road make such a fundamental change in the original proposal. As I say, I think your proposal has some merit, but I think it also has tended to poison the entire tax bill, which I think overall the tax bill is a fairly good bill.

Senator SYMMS. Thank you, Senator Byrd.

I would ask unanimous consent that a Dear Colleague letter of mine of December 10, and substantial material, be submitted in the record immediately after the questions I asked of Mr. Chapoton.

Now I recognize Senator Boren.

Senator BOREN. Thank you, Mr. Chairman.

Mr. Chapoton, returning to the question that Senator Baucus asked you earlier in terms of the distribution of the benefits. I still have difficulty. I confess the same difficulty he had in following your answer in saying that all of the benefits flow to the lessee.

Mr. CHAPOTON. Less the transaction costs.

Senator BOREN. Except the transaction costs.

Now, why would the lessor be willing to go into that? I think you said, well, he is not going to go into it out of the goodness of his heart to help some lessee out here who needs it. There has to be some benefit for him. As I understood it, you said that there were averaging about a 15-percent rate of return in terms of the tax benefit by for it earlier, and they are going to get 115 percent of the benefit later.

Does that have no revenue impact to the Treasury? How are both parties ending up with more than 100 percent of the benefit without the Treasury sustaining some loss?

Mr. CHAPOTON. It is not more than 100 percent. The benefits total 100 percent. Let me go through that for just a minute.

Look at one company that is making an investment, and that investment will yield it a dollar of tax benefit a year from today.

Senator BOREN. I understand that.

Mr. CHAPOTON. That is worth, let's say, just taking a figure out of the air, a 15-percent-discount rate. Let's say that it places a value on that of 85 cents. That means the current value of that asset, if you will, is worth 85 cents and it will be worth a dollar a year from now.

Senator BOREN. I understand that.

Mr. CHAPOTON. If it sells that asset, the tax benefit, for 85 cents, it receives its full value for it, and also transfers the income that asset carries with it. That is the 15 percent growth in that asset, so that it will be worth $1 a year from now.

So the buyer, the lessor in our example, will pay that amount for that income. It is an assured source of income, but the tax benefit will be available in the future. The buyer will receive a 15-cent net benefit, because it pays 85 cents for a $1 benefit. It receives 15 cents, and the seller gets 85 cents; the total benefit is $1.

The parties will negotiate this, and maybe the buyer will not pay 85 cents, maybe he will pay 84 cents, in which event he might make a little more return, but the seller will get less. So the benefit is traded between the two of them.

Senator BOREN. Then it is accurate to say that a portion of the benefit in terms of the dollars lost to the Treasury in taxes that would otherwise have been collected, a portion of the benefit does go to the lessor?

Mr. CHAPOTON. I think that is true, Senator, but keep in mind that the benefits all have value greater in the future than they do now. So if, in our example, you pay 85 cents, that is 100 percent of the current value of that benefit to the seller.

Senator BOREN. I understand that.

Your estimate that the greater proportion of the benefit of this provision, by far, flows to the lessee, who supposedly is a company that has had losses and needs to take advantage of it; on what is that based? How many of those actual deals have you looked into, and taken actual figures from or monitored in order to come up with that estimate?

Mr. CHAPOTON. We have looked into very few of the actual deals. We have seen reports of the deals and what parties are paying for the benefits. It is not a complicated computation for the value of

the equipment; all you have to see is what percentage of that value is being paid.

Senator BOREN. Have you looked, for example, into the actual transaction which I think is one of the largest, if not the largest, between Ford Motor Co. and IBM?

Mr. CHAPOTON. We have not looked at the actual figures, no, sir.

Senator BOREN. It is my understanding that this information may be available to the committee. It may still be on a confidential basis.

I would appreciate having in writing, after you have looked at that, an analysis of that. As I say, it may be confidential, and I think it would be best to have you look at it objectively, but I would like to know if after looking at that and some other actual transactions, you would still estimate that 85 to 90 percent of the benefit is flowing for every dollar involved in these transactions to the lessee.

In other words, you are basing it upon your rational analysis of where you think those benefits are going.

Mr. CHAPOTON. And on reports of what people are paying for the benefits, and on our discussions with attorneys involved in these transactions. We have seen the actual papers on a few transactions.

Senator BOREN. You say a few, what percentage?

Mr. CHAPOTON. I would say that it would be less than 10.

Senator BOREN. So there is no certainty that your estimates of where these benefits are flowing are fully accurate.

Mr. CHAPOTON. There is no reason to believe that the parties, when they tell us the percentage in the marketplace that is being paid for these benefits, are misleading us. But indeed, if they are misleading us, it is true that the benefits are not ending up where we want them, but the tax cost to the Treasury is not greater either.

Senator BOREN. You have used the estimate here of $20 billion in terms of the first 6 years. It is my understanding that Treasury has access to estimates of what it is going to cost over a 10-year period, and that figure may be closer to $80 billion. Is that correct?

Mr. CHAPOTON. Senator, we have not run the 10-year estimate. We would be getting pretty speculative out that far. We could take a run at it, but it is not available. It is not in our forecast.

Senator BOREN. There has been talk in terms of the change between the existing leasing rules and this change, and I understand that comparisons have been drawn favorably to the new rules. Isn't it also true that we are encouraging a far greater volume of these leasing transactions under these rules, and in terms of loss to the Treasury it is going to be much, much greater because we are having a threefold to fourfold increase in the number of these leasing transactions?

Mr. CHAPOTON. We are obviously encouraging the volume of leasing transactions under these rules, yes, sir.

Senator GRASSLEY. Mr. Chapoton, has the Department given any consideration, both before enactment of this legislation or since, to putting any sort of limit on the amount of dollars that a corporation who leases could acquire?

In other words, following the theory that you know the advantage of leasing is to make use of the investment tax credit to encourage your recapitalization, retooling, or whatever is involved, and for those companies that are purchasing the investment tax credit from a corporation that doesn't have any profits to put against it, has there been any effort or any thought to put a ceiling on the amount that any one corporation could accumulate in purchasing?

Mr. CHAPOTON. Senator, we think that this would make no more sense than putting a lid on the dollar amount of cost recovery deductions that a corporation could obtain.

Senator GRASSLEY. So, in other words, as long as the investment tax credit is used through leasing or any other way, as long as it is used up, regardless of how concentrated that might be with a few major corporations, there is no economic harm that you see in that concentration?

Mr. CHAPOTON. No, we see none because, as I explained, virtually all of the benefit of the cost to that user is going to the party that is doing what we want him to do, and that is buying equipment, placing equipment in service, and paying a great deal more for the equipment, of course, than the tax benefits involved.

Senator GRASSLEY. Let me suggest to you that although I have not explored it fully and I may come to another conclusion, it seems to me like what we have been able to read so far, that there has been a concentration of these leases with a few industries.

Mr. CHAPOTON. Senator, there is a free market out there. These tax benefits are available to all parties who have tax liability. That makes the marketplace work well. They are no more beneficial to a big company with tax liability than they are to a small company with tax liability. The worst thing we could do is eliminate some purchasers, and thus make the market less efficient.

Senator GRASSLEY. What about the disregarding the safe harbor leases in computing other credits, like the foreign tax credit, or other tax preferences that are given? The safe harbor leases come in ahead of these. If the leases were applied after these other credits are taken, wouldn't that be a more fair application of the credit?

Mr. CHAPOTON. It seems to me that what you are suggesting is that the other benefits are, for some reason, inappropriate. I think we would suggest that you reexamine these other benefits because otherwise you deny the investment incentive to that company. If anything, I think we would want to leave the investment incentive there, and decide whether we have benefits that are not otherwise appropriate for some reason.

Senator GRASSLEY. In other words, your position would be to know there is kind of a multiplying effect of various tax preferences, that the leasing provisions outweigh the benefits of any of these others, and they should be compromised as opposed to those leasing provisions.

Mr. CHAPOTON. In this provision, you take the taxpayers as you find them. If they have got other benefits, that will be a factor in their decision as to whether or not to lease their equipment. But we think the incentive to put new plant and equipment in place should be retained through leasing or directly. If you have other

provisions that are undesirable, they ought to be reexamined independently of this.

Senator GRASSLEY. Senator Bradley, it is your turn.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Chapoton, when provision was first proposed my recollection is that people were saying it would cost about $9 billion; is that right?

Mr. CHAPOTON. Senator, the revenue estimates are the same as they were at that time. The cost through 1986 was $28.1 billion.

Senator BRADLEY. The rationale that the committee operated under, in approving this provision was that we wanted to assist industries that were troubled, that were in a loss position, and that therefore couldn't take advantage of ACRS and the ITC. As we considered this, there were two possibilities: One was this route, and the other was some kind of refundable tax credit.

Why didn't the administration support the refundable tax credit?

Mr. CHAPOTON. As I explained earlier, the refundable tax credit has nothing to do with future investment incentive. Any type of rule in connection with ACRS should be tied to future investment. The leasing provision, as I explained, is tied directly to new investment and that is the result we wanted.

Senator BRADLEY. Earlier you said that you felt that the purpose of the provision was to reduce the cost of capital for all firms.

Mr. CHAPOTON. That is correct.

Senator BRADLEY. It is not simply to target particular firms; is that correct?

Mr. CHAPOTON. That is correct.

Senator BRADLEY. Would you deny that there is a particular advantage to firms that are in a tax loss position?

Mr. CHAPOTON. A particular advantage under the leasing rule?

Senator BRADLEY. Yes.

Mr. CHAPOTON. No, it is clearly not a particular advantage. There is an advantage to any company that doesn't have current U.S. tax liability. A loss company would be a prime example of that.

Senator BRADLEY. Would you see any significant additional reason why the U.S. Government should assist companies in a tax loss position even though they in fact have highly profitable operations?

Mr. CHAPOTON. As I have explained, it makes the loss company's investment cost less because the tax benefits will become available to the loss company.

Senator BRADLEY. What about the cash position?

Mr. CHAPOTON. It will reduce the cost of equipment and, therefore, help their cash position.

Senator BRADLEY. What about that in the context of the recession that we are now in? Let's say that you operate a company, and your sales are down dramatically. You are forced to lay people off. You are forced to employ less of your plant and equipment. You are forced to a potential bankruptcy situation unless you get cash somehow. One of the ways you get cash is by selling your investment tax credit.

The point I am getting at is, how much deeper would the recession be without this provision?

Mr. CHAPOTON. Senator, let me correct a misconception about that which seems to be a widely held one. A company is not going to enter into one of these transactions to improve its cash position. Its cash position is diminished because it must make an investment much, much greater than the cash it will receive from selling the tax benefit.

Senator BRADLEY. Depending on the discount rate; is that right?

Mr. CHAPOTON. The compa ıy—the user of the equipment—will take the best price it can get for the tax benefits.

Senator BRADLEY. The discount rate assumed in the Economic Recovery Tax Act was very low because it was assumed that inflation would drop, and then we would have interest rates down at 7 percent.

Mr. CHAPOTON. The user is still receiving from the lessor only a portion of the total cost of the equipment.

No, the user is not going to pay anything like 100 percent of the cost of the equipment. We hope that what it receives from the lessor is as near to the present value of the tax benefits as possible. But notwithstanding that, that firm must on its own, or through its creditors, or through its stockholders, come up with a lot more capital to make the purchase of equipment. So it is not going to be a net cash plus for the company. It will simply reduce the cash outlay.

Senator BRADLEY. But they might not have made that purchase otherwise.

Mr. CHAPOTON. Absolutely, that is our whole point. They might not have made that purchase otherwise. If you are talking about loss companies, the only way loss companies can become profitable is to make profitable investments.

Senator BRADLEY. Now let's look at the idea of reducing the cost of capital for all firms, and look at the interaction of this provision with the other things that Senator Grassley mentioned, let's say, the foreign tax credit.

Let's say I operate a company and I want to buy a piece of equipment, whether it is a drilling rig or a computer.

Let's say that I get an investment tax credit from that, and depreciation in this country. Let's say, I then decide to sell the tax credit to a willing purchaser, that is income for me. Then let's say that I offset that income with foreign tax credits that I have accrued because of other operations.

Do you think that that is the Tax Code operating in a neutral fashion to encourage investment and reduce the cost of capital for all firms; or do you think that it is a special benefit to particular firms that have the advantage of other tax benefits like the foreign tax credit?

Mr. CHAPOTON. There are several problems with that. No. 1, the foreign tax credit will not be available unless the company has foreign source income. The sale of the tax benefit would be U.S. source income. In addition, the company has income, but it also has a deduction from the transaction itself. That is, it must make lease payments which are deductible. It will have income from the interest, but the interest will never——

Senator BRADLEY. Isn't there the rental income?

Mr. CHAPOTON. The user pays the rent. The lessee is selling the property to an owner, and it is paying rent after that for the use of the property. It is receiving the payment of the purchase price, part of which will be interest which will offset in part the rent deduction, but not in toto. In fact, the red chart here, Chart II, shows that the lessee ends up with a net deduction, which is small in the early years and increases over time.

Senator BRADLEY. Let me ask this one last question, if I can. What do you think the average person's perception of the Tax Code is when he can't sell his losses to corporations for whatever reasons. Do you think it creates the impression that the Tax Code is fair, that the Tax Code is operating in a way that is neutral to encourage investment; or do you think he feels that somehow or another something has happened here that he has not gotten a piece of?

Mr. CHAPOTON. I think the perception is an important point, Senator Bradley. The fact is, though, these are not the sale of losses. These are the sale of benefits which flow from spending money on new plant and equipment. The taxpayer—the corporate taxpayer or the individual taxpayer, by the way, the benefits are not limited to corporations—makes that investment, a large investment, and receives a reduction in the net cost of the equipment by reason of obtaining the tax benefits. It receives only the tax benefits that a taxable taxpayer could otherwise obtain without leasing.

Senator BRADLEY. If that is so, Mr. Chapoton, then you ought to be holding a few seminars with the press, because that is not the popular conception among the press, nor among a great number of U.S. Senators. So, either there is an argument contrary to that, or you haven't got that story out very well.

Mr. CHAPOTON. I would agree with you that a few seminars with the press might well be in order.

The CHAIRMAN. I am sorry I had to be out, but we have the Farm Conference Report on the floor, and it is a matter of great interest to people who eat, and also those people who farm.

It has been suggested by some that we just ought to repeal the leasing provisions, and you may have touched on that in my absence. What effect would repeal have?

Mr. CHAPOTON. Senator, it would restore the inequality of cost of investment between firms. It would exacerbate the problem of companies that don't have current tax liability having to pay more for their equipment than companies that do have current tax liability. It would put great pressure on the old leasing rules.

They would be much more heavily utilized than they were in the past, much more heavily utilized. We have had many problems with those rules, with the airlines having to purchase back their airplanes at the end of the lease term and all the other problems that Senator Long mentioned.

Finally, it would certainly encourage, and we would expect, a large number of tax motivated mergers to occur.

Senator LONG. May I, because I just want to be sure that I heard you right in that connection.

Did I understand you to say that 46 percent of the companies would not be able to benefit from the accelerated depreciation provisions that we passed unless we had these leasing provisions?

Mr. CHAPOTON. In terms of numbers, that is correct. I am talking about the numbers of corporations that do not have current tax liability in any year: 46 percent before the adoption of the accelerated cost recovery system.

Senator LONG. Most of those are small business?

Mr. CHAPOTON. Yes, most of those are small business.

Senator LONG. Can you explain to me how we can very well go out there and tell just the ordinary little guy that is going into business and is trying awfully hard to make a profit and is having a tough time making it, that we voted a bill that would give General Motors a big tax advantage, but we had an opportunity to let him share in the benefit of it, and chose to kick him out so he couldn't participate?

How would you explain that to the average little manufacturer or grocery store back in your hometown? We had a chance to vote where everybody could benefit, but we will help the rich, and those who will get lots of money.

The little people who are working awfully hard to survive and sacrifice, trying to make their little business go, to those we say, "Too bad, fellow, you see, you are not rich, you are not showing a profit right now. If you can survive for a few years, maybe you can get in on this deal. Otherwise, too bad, good bye, my honey, I am gone." I have got those people in mind.

How are we supposed to explain that to our constituents that we voted to put the other guy in and leave them out.

Mr. CHAPOTON. We think that it would be unfair to explain it to them.

Moreover, a lot of those companies do leasing under the old rules. Their typewriters are leased. Their computers are leased. We see it all the time. There was a big market out there, but it is much more expensive to these companies because they received a much smaller portion of the benefit under the old rules, as we have explained.

Senator LONG. If we vote againt this, we would be voting to say that that middleman can really shake him down and make him pay a high price to get the benefit that Congress meant for him to have also. Wouldn't that be the case?

Mr. CHAPOTON. That is correct; the middleman does better under the old rules.

Senator BRADLEY. Then there would be more of those people, and the recession deepens; is that right?

The CHAIRMAN. It is not going to deepen, no.

Can newspapers use this provision? [General laughter.]

Mr. CHAPOTON. Yes, sir, they certainly could.

The CHAIRMAN. They make a profit, they make more profit than most anyone else, so they are eligible.

Mr. CHAPOTON. Well, there are newspapers that make profits who could be buyers of benefits.

The CHAIRMAN. Television networks, and others who condemn the program could probably use it; is that possible?

Mr. CHAPOTON. We don't know of any specifically, but certainly they are not excluded.

The CHAIRMAN. I think perhaps we need to watch it carefully, but I would hope that those who condemn it would at least try to

understand it. I don't understand it, but I don't happen to condemn it yet. [General laughter.]

That is not a requirement in this town, so don't misunderstand me on that issue. [General laughter.]

Either to understand it or to criticize it. All you have to do is to stand up on the Senate floor, or the newspaper, and say that it is a bad program, and some people will listen. We have all done that, or almost every one of us.

So you are not advocating any change at all in the program?

Mr. CHAPOTON. No, sir we are not. We are in total support of it.

The CHAIRMAN. You don't see anything that you would do in a different way if you had a little more time?

Mr. CHAPOTON. No, sir. We have reviewed the provisions carefully in light of the current publicity.

The CHAIRMAN. Are you willing to indicate to this committee that if there are areas that because of the provisions may lead to abuse; or if someone benefits who was not the intended beneficiary, will that information be made readily available to this committee?

Mr. CHAPOTON. Yes, sir. We will be obtaining information from tax returns and from forms that will have to be filed on leasing transactions. We will analyze the specifics of deals that are being consummated in that way, and we will certainly be happy to provide that information to the committee, and work with the committee if it decides that any of the benefits are unintended. But to date, we do not see that happening.

The CHAIRMAN. What is the position of the Treasury Department on the use of so-called ITC strips under the "safe harbor" leasing provision?

Mr. CHAPOTON. Under the regulations as we have issued them, and they reflect our interpretation of the statute, the so-called ITC strip, whereby the parties transfer only the credit and not the deductions, is not permitted. We think it is difficult to read the statute as permitting that.

The CHAIRMAN. Since corporations are the intended beneficiaries, and you answered this question in part before, why not make the investment credit and a portion of depreciation directly refundable to them, thus cutting out the revenue losses that would go to middlemen and taxbuyers under leasing?

Mr. CHAPOTON. As I did answer before, we think the leasing transaction is much preferable to any type of direct refundability. No. 1, the purchaser does the policing of the transaction. It has to make sure that the equipment is in place, and that it continues to be used in this country as intended. If the equipment does not continue to be so used, that party, the lessor or the buyer of the tax benefits, has to recapture those tax benefits. So he has an incentive to make sure that the equipment is used as intended.

In addition, because of the economics of transactions, significant tax benefits remain at the back end of the transaction with the use of the equipment. The parties themselves are able to negotiate with respect to the tax benefit. We think the constraints within which they must negotiate, the general rules that we have had in the law for some time, work quite well. This would be much preferable to any type of direct refundability, which would have to be spread out over a number of years.

The CHAIRMAN. When will be the first possible time that you will be getting credible data?

Mr. CHAPOTON. Senator, we are probably going to ask for information on leasing transactions consummated in 1981 to be filed with the Internal Revenue Service at the end of January or shortly thereafter. That matter was raised by the Ways and Means Committee yesterday. We have been looking at that independently, and we think we will require that.

That data will come in and it will take a matter of months before it is in usable form. In the third quarter of next year, we might have some preliminary information.

The CHAIRMAN. What I am trying to determine is when you will be in a position to tell this committee and others who have questions about the program, and I don't suggest that the questions are not legitimate, if in fact the things predicted by the administration are taking place insofar as the provisions are concerned.

When is the earliest possible time that even fragmentary information will be available?

Mr. CHAPOTON. When we request that information, we can pull out specific transactions immediately, of course, but it would not be a broad range of data. We could look at transactions in the first quarter of next year.

The CHAIRMAN. You will have some idea in the first quarter if, in fact, small business benefits, or, in fact, new companies, such as Newco, the company you used in your example, or if, in fact, as some indicate, that the benefits are all going in the wrong direction. You will then be able to give us some information?

Mr. CHAPOTON. We can give some preliminary information, yes, sir, and we will act with the committee to review that information. We will pull out that data as quickly as we can.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

First let me say, Mr. Chapoton, that I have great confidence in you, and I think that our country is very fortunate to have you in the very important position that you are in.

Mr. CHAPOTON. Thank you, Senator.

Senator BYRD. My comments with regard to this provision, of course, have nothing to do with my lack of confidence in you. I think we are very fortunate to have you.

Mr. CHAPOTON. Thank you, Senator.

Senator BYRD. There was an exchange a moment ago in regard to this being a small business provision. There are grounds for argument, I think, as to the merits of that proposal, but I can't see that this could be labeled a small business proposal.

Right or wrong, and I am not against big business at all, this is basically a big business proposal. I think big business deserves to be treated fairly and appropriately. My only concern is whether—you did not vote for this, you only recommended it, it is we in the Congress have the responsibility—whether we went too far in giving benefits to business, in particular to big business in that last tax bill. I am beginning to have second thoughts about this provision. I am not going to make a categorical statement today, but I am inclined to think that we made a mistake in approving it.

Be that as it may, I think the committee needs to gain on this matter, and we ought to have some witnesses who will or can present a different viewpoint from that of the Treasury, because I must say frankly I am not clear in my own mind as to whether this provision should be repealed or should not be repealed. I am inclined to the view that it should.

Mr. CHAPOTON. I must say, Senator, that we are not selling it as a small business matter either. It is going to help large and small business.

Senator BYRD. I am glad to get that straightened out.

Mr. CHAPOTON. But it is a fact that one cannot ignore the numbers of nontaxable corporations that would be denied, and are denied, incentives for new investment in plant and equipment without leases under the old rules, mergers under the old rules, or leasing under these new rules.

We think that those facts make efficient new rules desirable, and small business will benefit along with large business.

Senator BYRD. The difference between the old rules and the new rules, the new rules may be better, but the difference is one fundamental fact, that it is going to cost $30 billion in revenue to go to the new rules. Is it wise to spend that $30 billion in that way? You think it is, and others think that it is not.

Mr. CHAPOTON. We think it is, and an important element in that, Senator, is that we have exacerbated problems under the old rules when we speed up cost recovery deductions. It is not the old rules with the old law. It is the old rules with the new deductions.

Senator BYRD. This proposal costs $30 billion more than the old proposal, isn't that correct?

Mr. CHAPOTON. We think the induced leasing under the new proposal will cost $30 billion through 1986, yes, sir.

Senator BYRD. And huge additional sums beyond that?

Mr. CHAPOTON. Additional sums beyond that. As I did point out, we thought it preferable to have that loss spread out through the use of ACRS throughout the business community and reduce somewhat the benefits otherwise provided in the ACRS system.

Senator BYRD. Thank you.

I will not ask you a question on this, but if the chairman will permit I will make a brief comment. I don't think I want to put you on the spot by asking you this, but I was very disappointed to read yesterday that the President's Council of Economic Advisers have been asserting that there is no relationship whatsoever between deficits and inflation. It seems to me that this is totally the opposite from what the President of the United States has been telling the country, not only when he was a candidate but after he took office.

I was astonished by the remarks made by Dr. Weidenbaum and his associates on the Council of Economic Advisers. One of them said that we ought to have at least a $60 billion deficit. The whole implication is that the more deficit we have, the better off the country is. Mr. Niscannon said:

> Just think, the way you ought to look at this deficit is that now property that the United States owned 20 years ago was worth $20 billion, and now because of inflation it is worth $250 billion. We ought to be thankful for what is going on, and what has gone on through these 15 years of deficits.

I would hate to see the administration that I have supported so strongly take such a view as that.

I assume that that is not the President's position. I realize that you can't speak for him, so I am not asking you that as a question. But I am going to assume that this is not his position until he says so himself. But if that is the position of the present administration, I think it is going to make it very difficult to expect Congress to hold down spending. Congress does not need an invitation to spend anyway, it has proved that over the years.

Senator BRADLEY. I think the economic adviser will be going the same way as the general who advocated the possibility of a limited nuclear war.

The CHAIRMAN. I have not tried to find out what is going on, but I understand that we are still aiming toward a balanced budget. The last time I heard the President, he was indicating that With the cooperation of everyone, I am sure that we are going to achieve it.

There is another matter that is even more important than this provision, and that is the economy. I would not want to get into that at this time.

Senator BOREN. Mr. Chairman, I want to associate myself completely with the remarks that Senator Byrd has just made, and I will go one step further. I think he should have fired the gentleman before nightfall. I think that he should have removed him as quickly as he did the general, because I thought the statement was a betrayal of all the American people thought they were going to get out of this administration.

I feel as strongly as you do about it, and I wanted to pound the table and say, "Amen," when you made your statement.

Also I feel very strongly about what you said here. We consider that we are spending $30 billion, perhaps $80 billion, on this kind of tax break over the next decade, and we are talking about publicly imposing new kinds of tax burdens, excise tax on telephone service, limited deductions on mortgage interest, and other kinds of excise taxes.

I want to certainly serve notice right now that I will not be supporting them. I will certainly support repeal of this kind of tax break before I would begin to support any kind of tax increases on the average American person. I think it would be absolutely reprehensible in the eyes of the American people. I think that it is absolutely indefensible.

I hope that the administration is fully informed that some of us who supported their policies earlier will part company, not only gently but forcefully, if there come proposals from this administration to increase excise taxes on the average American, while this kind of nonsense goes on.

There are going to be some of us who will be in outright warfare. We are going to feel that we have certainly been led down the primrose path. I hope that that is conveyed because I could not feel it any more strongly.

When we pick up the papers, and I wondered about it when you say that there is no changed concern, when we read that Occidental Petroleum Co., which is certainly not hurting, got a sale of $200 million of tax benefits under this proposal. Is there no concern that

we look into companies that are very profitable, which are sheltering their overseas investments and taking advantage of this? Are we not even going to look at that?

Mr. CHAPOTON. Senator, as I said, the perception is always a concern, but the fact is that the administration proposed, and the Congress decided to give, very substantial benefits to parties who make a significant investment in new capital, plant, and equipment.

Senator BOREN. In other words, you think that it is fair and equitable to give a huge tax break to Occidental Petroleum Co., which is a very profitable company, while the Treasury has under active consideration imposing additional excise taxes on telephole service, for example, to retired citizens. Is that fair?

Mr. CHAPOTON. Senator, it is fair.

Senator BOREN. It is fair?

Mr. CHAPOTON. I think it is fair.

Senator BOREN. Your definition of fairness is certainly not the same as my definition of fairness, and I would like to hear you defend that all across the country.

Mr. CHAPOTON. We decided to give any company that has tax liability great tax breaks, and that was clearly done, because they make investment in capital and because otherwise we are afraid that they would not have the incentive to make the investment. We clearly did that.

The concern you are expressing is where they do not otherwise have current U.S. tax liability for reasons of other provisions in the code.

Senator BOREN. It seems to me, and I would hope that you would look into the reasons why companies can take advantage. It is one thing to talk about a company that is experiencing severe economic difficulties, and the one that needs to be rebuilt and have an opportunity to retool, taking advantage of such a provision. It is quite another, I think, to say that companies that are very profitable, that really don't need additional tax incentives, should be able to do so at this kind of cost to the Treasury.

If we had unlimited resources, it would be different. But when we spend $30 to $80 billion on this kind of proposal, it means that it has to be made up elsewhere, unless we are going to adopt this theory that the deficit doesn't matter.

But if it is going to be made up elsewhere, where is it going to be made up? If it is going to be made up on the widow's telephone bill with an additional excise tax, or on the person who is paying on a home mortgage, count me out, and I think count out 99 percent of the American people. I think there are more people out there who are concerned about equity than are concerned about the enhancing the profits in this manner.

Going back to Senator Byrd's question about small business, can individuals buy these tax breaks, can they be lessors, can individuals be lessors under this provision?

Mr. CHAPOTON. No, they cannot. It is limited to corporations.

Senator BOREN. Can subchapter S corporations be lessors under this provision?

Mr. CHAPOTON. No.

Senator BOREN. Why not?

Mr. CHAPOTON. Because the rate differential between individuals and corporations could cause a problem.

Senator BOREN. What do you mean, cause a problem?

Mr. CHAPOTON. The marketplace would act differently. That is, individuals might be in higher tax brackets than corporations. It is less significant now, but when it was designed, the top rate was 70 percent. It has now dropped to 50 percent, which is closer to 46 percent.

Senator BOREN. You are thinking that there might be abuse of this, that too many people would take advantage of it?

Mr CHAPOTON. Yes. We think if you have a rate differential, there could probably be abuse, yes.

Senator BOREN. So the conclusion is that it is all right, it is not an abuse for a large corporation to buy these tax benefits. It is an abuse for an individual, or subchapter S, or a small person, or a small operation to act as lessor under these benefits; is that the standard that is being followed?

Mr. CHAPOTON. Senator, the buyer is making a return on the dollar invested. There are ample funds in the corporate sector to provide these benefits to people who are putting the property in service, and that can be individuals, partnerships, subchapter S corporations, or normal corporations. The problem with individuals doing it is the rate differential, the tax-shelter-type problems. We thought that was not desirable.

Senator BOREN. It just seems to me that there is a double standard being followed. I would hope that we consider that we are dealing with limited resources, we are dealing with limited funds. We have to do something about the deficit. It is one thing to support an across-the-board tax reduction, which I supported, but it is another thing to support acceleration depreciation, capital formation incentives, which I support.

It is quite another thing, when we are in a period of limited resources needed to act on the deficit, to say that we are going to trade these kinds of tax breaks for the tax increases. I am anticipating that the administration has these under consideration.

I would just hope that in the policymaking councils that you would carry back that there are at least some who very actively supported earlier attempts to come up with a fair tax bill that are going to be absolutely incensed if we talk about giving these kinds of tax breaks to the Occidental Petroleum Cos. of the world, and then put additional tax burden on average citizens. I think that reprehensible is too mild a term to use.

The CHAIRMAN. I might say, there are some who have the same view about the depletion allowance, which is very important to me and the Senator from Oklahoma.

Senator BRADLEY. Was that leading to my questioning, Mr. Chairman?

The CHAIRMAN. It probably was, yes. I think it depends on who is getting the break.

Senator BOREN. I don't think it does, Mr. Chairman.

Senator BYRD. Would the Senator yield just a moment to ask a followup question?

Senator BOREN. Certainly.

Senator BYRD. You mentioned, in reply to Senator Boren, rate differential. Are there not rate differentials between corporations?

Mr. CHAPOTON. The marginal rate differential between the buyer and the seller could make a difference in the transaction.

Senator BYRD. Of course, some corporations pay as little as 17 percent.

Mr. CHAPOTON. That is correct.

Senator BYRD. Some corporations pay 17 percent, and some corporations pay 46 percent.

Mr. CHAPOTON. That is correct.

Senator BYRD. So you have a tremendous differential there.

Mr. CHAPOTON. That is correct.

Senator BYRD. The larger corporation, the one that pays the 46 percent, the prosperous corporation, gets the greater tax advantage, does it not?

Mr. CHAPOTON. Actually, the greater benefit will go to the smaller corporation that pays the lower rate. He can offset these deductions against higher rate income of the larger corporation.

Senator BYRD. But the larger corporation offsets the 46 percent.

Mr. CHAPOTON. That is correct, but he is paying for deductions, and that does put the smaller corporation in a better position if it is a lessee. It does not improve the position of the large corporation.

Senator BYRD. Thank you.

Senator BRADLEY. Mr. Chapoton, don't you really think that this provision, this leaseback provision, is just the straw that breaks the camel's back? You combine the ACRS, the investment tax credit, and now the leaseback provision, and what you have basically done in the Economic Recovery Tax Act is to give too much away.

You have corporations out there that will be paying no taxes next year. They will be paying no taxes because the system is too generous, and they will not be able to show a significant increase in investment.

In the Finance Committee, while we were debating the bill, a couple of us proposed what I thought was a solid depreciation program, but one that just didn't give away the whole store. But it didn't pass, and yours passed. Now we get the prospect of many corporations paying no taxes.

I have the experience of corporate heads telling me that. They are embarrassed, but they say, "What do you expect us to do? It is in the law." I don't have any answer for them; yes, it is in the law. No one looked at that during the tax debate. No one made the point. Three of us tried, but we were not heard.

This is too generous, not because we do not need to rebuild America, which we do, but too generous because subsidizing capital will stimulate its formation but it won't necessarily lead to increased productivity or competitiveness. Moreover, a backlash was inevitable. That is what you are seeing now, and it is all being focused on this leaseback provision that has become the cause celebre of Washington in the last couple of weeks or months.

The real question is, when are you going to admit that you went too far, and what are you going to do about it? The purpose of these provisions in the ACRS was to improve productivity; is that right?

Mr. CHAPOTON. That is right.

Senator BRADLEY. Improve productivity by giving incentives for investment in plant and equipment. But the real problem is that the combination of the accelerated depreciation, the investment tax credit is simply too generous. Once you've done it though, then you may have to have the leasing provisions to preempt the takeover, mergers, and other investment aberrations that would otherwise occur. Together this package is likely to distort economic decision-making. Corporations will be unduly biased toward investment in plant and equipment and away from labor, which is equally important in improving productivity.

So my question to you is, when are you going to admit that; what do you propose to do about it; and wouldn't, in this circumstance, lowering the corporate rate and refundable tax credits for those companies in trouble, be a better approach?

Mr. CHAPOTON. Lowering the corporate rate would be desirable, no doubt about that. I think your comments go to the broader questions, and are quite appropriately, whether ACRS itself is too generous. These provisions are an integral part of ACRS, and we think would be a necessary integral part of any change in the depreciation rules to make them more beneficial. Indeed, they would have been an improvement under prior law.

The question of whether ACRS is too generous was debated last summer extensively. Indeed, the Ways and Means Committee came up with a bill——

Senator BRADLEY. You have heard people on this committee today who supported the whole program, and they are raking you over the coals on this little leaseback provision as if this is the whole game, which it isn't.

Why are they doing that? They are doing that because they are hearing from people out there that they are not able to take advantage of these portions of the tax code which are supposed to improve productivity. What I am saying is that you had better be developing a contingency plan because you see the storm coming.

I think that whether you supported the tax bill or you didn't, there was a consensus, and I think there still is a consensus out there, for improving U.S. competitiveness and productivity. We recognize that improving investment and getting new equipment in plants is essential to that. I am saying, don't blow it.

Mr. CHAPOTON. Senator, I think your advice is well meant. I would simply point out that even under the new Economic Recovery Tax Act, we have cost-recovery allowances about equal to, and perhaps not even as good as those of some of our trading partners such as the United Kingdom and Canada. It is a question of how generous cost recovery should be.

Our ACRS system is generous, we think, but, as we have gone through this morning, from time to time, it is always tied to new major investment. We think that is a desirable way to accomplish it.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. I don't want to keep Mr. Chapoton, Mr. Chairman.

Let me say to you that I have never questioned the good faith of the Treasury in this matter. I think you have had an absolutely

clear problem if the depreciation schedules were going to be changed, which they were. Without this leasing provision or some such, there is going to be a massive amount of takeover response that had to happen. There were, however, those of us who thought that the depreciation schedule had gone beyond what it had to be.

We had a stronger interest in this committee in capital gains reductions, which had the quality of responding in a tax manner after an event and in the event of a successful event. I think our reduction in 1978 has proven effective.

What troubled us in all this, just apart from the question of what kinds of changes are going to take place in corporate investment patterns just in consequence again of the tax laws, but the overall level of tax loss in that bill. We pleaded that it was too much, that it was an auction of the Treasury which will take place.

Now you have a problem of a tax bill intended to increase investment, but because the deficits loom indefinitely, the interest rates have been at a level where there has not been the investment response that you had expected.

Mr. CHAPOTON. I think it is a bit early. We are clearly entering a recession which is having an adverse impact on investment decisions.

Senator MOYNIHAN. You have done an awful lot of damage. Do you realize what you have done to the Republican members of this committee, and other committees, who heard yesterday that deficits don't matter. Psychologists can turn white rats into a catatonic state by that sort of statement. [General laughter.]

You really have to think of some therapy sessions. Get them down and surround them by very wealthy men, and have the very wealthy men assure them over and again, quietly, that deficits don't matter. It doesn't matter what you heard in your youth, you are going to grow up now. The more money you owe, the richer you are.

Seriously, we can legitimately expect from the Treasury some reports on investment progress. What are the sequences that were projected, and what has happened? It is not enough to say, early. I dare to think that in President Reagan's third term that the program is just getting underway, the newest program.

You have been in office a year, or not quite. You have had an enormous tax bill. Can you not give us in the early part of the year some comment on capital investment in the present calendar year as you would have expected it without the tax bill, and what has happened with the tax bill? If you will be open with us, we will be a lot more generous with you the next time.

The next time that the Treasury comes up with a tax bill, I think you are going to find that it takes more than 2 days to pass it.

Mr. CHAPOTON. Senator, we will be happy to give the information and our analysis of it early next year. I think what we see in investment plans or on the drawing board will be very important, and that is certainly information one can obtain. The analysis is appropriate, I agree.

Senator MOYNIHAN. Mr. Chairman, I think it was very generous of Mr. Chapoton, and it would help this committee if we had some data as the Treasury sees them.

The CHAIRMAN. I just have a couple of other questions.

Don't the new leasing rules have the unintended effect of making past operating losses more valuable? Isn't this an area where we could make a technical change, which might be helpful to Treasury?

Mr. CHAPOTON. We could look at that, Senator. They definitely have that effect. We have looked at that aspect of it. It is true that if a corporation has losses and, therefore, has no current tax liability, those losses are more valuable, as you state, if leasing transactions can be entered into. I think that is a basic result of any proposal which makes the current incentives for investment work for everybody, but we can certainly look at that aspect of it.

The CHAIRMAN. I have been advised that one of the large TV concerns actually engaged in buying a tax benefit under the leasing rule. It is perfectly legitimate.

I would only say in concluding the hearing that I think you have some indication that there is some concern about this provision. Some who supported the tax bill have expressed that concern rather strongly and firmly this morning.

I think it does indicate that maybe if, in fact, the Treasury is convinced that it is a sound program, then somehow others need to be convinced or reconvinced that it is a sound program.

We are going to be asked, I understand, next year to take a look at certain tax increases, although I must disagree with Senator Boren, who is not here, as far as I know there is no one looking at mortgage interest deductions. In fact, we voted last week in the Senate and passed a resolution by unanimous vote that this would not be a tax expenditure we would address, nor do I know of anyone looking at increasing the excise on telephones.

In any event, with the budget deficits, if in fact they are anywhere near accurate, in addition to cutting spending, there will be, I assume, some pressure to look at revenue increases.

Senator MOYNIHAN. Mr. Chairman, budget deficits don't matter. Say it again. It is net worth of the Government that matters, and after we finish the Hart Building, our net worth is up already. [General laughter.]

The CHAIRMAN. You have been preaching that for a long time, and so far I have resisted. I think that it was a slip of the tongue, that they had been reading the wrong material.

In any event, when we have the choice on this committee next February, March, April, and May of, say, coming up with $20 billion in revenue, and you have leasing on the one hand, which the administration says is working perfectly, and you have excise tax increases or some other tax increase that is not presently effective, it is going to be a difficult choice for this committee.

I think the Treasury and the administration should know in advance that this provision is in some jeopardy.

Mr. CHAPOTON. Yes, Mr. Chairman, we can see the specific problem, and we will be addressing that.

[Whereupon, at 12:20 p.m., the committee adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

NEW YORK STATE
DEPARTMENT OF TRANSPORTATION
William C. Hennessy, Commissioner

1220 Washington Avenue, State Campus, Albany, New York 12232

DEC 17 1981

The Honorable Robert Dole, Chairman
Senate Finance Committee
2213 Dirksen Building
First and C Streets, N.E.
Washington, D.C. 20510

Dear Senator Dole:

The "Safe Harbor Leasing" provisions of the Economic Recovery Act of 1981 plays an important part in our ability to finance planned capital improvements to the aging transit system serving the New York City area and potentially for providing significant private sector financing for needed improvements for transit systems throughout the State and nation. Consequently, we are very concerned with any proposed modification of this provision.

While we did not appear at the hearings recently conducted by the Senate Finance Committee to present testimony on the "Safe Harbor Leasing" provisions of the Act, we would like to offer the attached testimony for inclusion in the record.

Sincerely,

W. C. HENNESSY
Commissioner

Attachment

cc: The Honorable Daniel Patrick Moynihan
The Honorable Alfonse M. D'Amato

We appreciate the opportunity to comment on the important matter of the safe harbor leasing provisions in the Economic Recovery Tax Act of 1981. That Act has offered ailing businesses a new source of revenue in an effort to keep alive certain industries which are in a traditional cycle and need help to get through the next few years.

The safe harbor leasing provisions also opened opportunities for government to seek private financing of its services, and to reduce the operating expenditures of government. The inclusion of "mass commuting vehicles" in the safe harbor provision is important to the transit industry, transit operators and has a considerable public benefit in services to transit users. The safe harbor leasing provisions are consistent with the Administration's emphasis to increase capital investment in ailing industries, encouraging a private sector investment in transit at very modest cost to the Treasury. There are no tax credits involved, so the Accelerated Cost Recovery System tax deferrals will eventually be repaid, the only cost to the Treasury being through inflation losses.

In New York State, there are transit operators ranging from the largest in the country to some of the smallest. All of these operators would like to benefit by the leverage leasing provisions, but the public benefit will be small for all the operators outside the Metropolitan Transportation Authority region unless some minor changes are made in the Act. In the recently publicized MTA/Metro-media leverage lease transaction, the MTA has shown that significant additional capital resources can be obtained from the private enterprise in exchange for tax deferrals. In the five year capital plan currently under review, the MTA expects to obtain $480 million in private investment to supplement government investment committed to capital improvements.

An investment of this magnitude without the tax deferral would require an additional increase of 5¢, to 30¢ per ride to produce the money from the fare box to pay for the capital improvements, but also making transit beyond the reach of some of our poor. The public benefit is therefore quantified in this case, and we can also convert the equipment purchase program into jobs for New Yorkers in the production and assembly of component parts for subway and rail cars and buses. Therefore, this investment ripples through the business economy, creating jobs and industry in our state. This is all possible because of the new safe harbor provisions.

However, the safe harbor leasing provisions for mass commuting equipment are very restrictive, as they are being interpreted by Treasury officials, and the public benefit of this program of capital investment is limited to only a very few transit operators. The benefit is largely lost to our rural, small city, and even urbanized area transit operators which are outside of the MTA district. There is an identifiable need to improve public transportation in these areas, especially in the rural counties of upstate New York. There are some provisions which, if modified, could extend the public benefit of private financing to these areas.

There is presently a requirement that a portion of these vehicles be financed with tax exempt obligations. In the current marketplace, many municipalities are understandably very uneasy about entering the tax exempt bond market and incurring debt just to encourage private investment in such equipment. If the bonding provision could be made optional, thereby allowing bonds to be used but not requiring their use, the participation in the program would likely increase

in all areas of the State, especially the rural areas. The cost in tax deferrals would be minimal, and the public benefit greatly increased. A second provision which would increase the public benefit would be to allow all commuting equipment to be leverage leased, even if a portion of the funds used to purchase the equipment came from the Federal UMTA capital program. Because no Investment Tax Credit can be taken, the tax loss is only tax deferral. Consider, however, that the revenue raised by using UMTA funds for leveraging can extend UMTA's buying power by 18 percent, money sorely needed by an industry which has been severely hurt by changing government policy. The tax deferrals in the first year of using UMTA capital funds for leveraging would not exceed $100 million nationally, money that will be paid to the Treasury over the life of the lease, although in cheaper dollars as described earlier.

A final provision to increase investment in transit is to change the safe harbor provision from mass commuting vehicles to mass commuting equipment and facilities. This would accelerate the replacement of aging equipment and allow transit operators to reduce operating costs through capital investment and by extending industrial engineering concepts to facility design for improved productivity. Operating savings will help keep transit available to all people at reasonable cost.

We would like to add a general observation so that you may clearly understand the importance of the safe harbor leasing provisions. We would argue that while these provisions may not have contributed greatly to the public benefit in some of the private sector business deals, local and State government should be included in the safe harbor. The infrastructure and economy of the northeastern section of this country is decaying. Our capital expenditure needs exceed our

ability to do this infrastructure work. Local and State governments need to encourage private investment in public works and thus achieve greater public benefit. Expanding safe harbor provisions to include local and State government will help the northeastern states supplement our present return on the Federal tax dollars we now send to Washington. The northeast can then continue the rebuilding of our older cities and towns. This is essential to our economic survival because it will help reverse the exodus of business and manufacturing from our section of the country.

Thank you for allowing us to go on record in support of expanding the leasing safe harbor provisions to increase the public benefit of their utilization. The changes recommended for mass commuting equipment will allow us to continue these essential transit services and reduce operating costs. Including local and State government within the safe harbor will help us find the capital to rebuild our decaying infrastructure.

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